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IN THE
Supreme Court of the United States

October Term, 1982

W. JAMES PRICE, ALONZO G. DECKER, JR.,
JAMES PARKER NOLAN, FREDERICK DEANE, JR.,
JAMES L. O'KEEFE, GREGORY S. DEVINE,
FAY A. LeFEVRE, JOHN K. STEVENSON,
HAYS T. WATKINS and HOWARD E. SIMPSON, et al.
Petitioners,

v.

PITTSBURGH TERMINAL CORPORATION,
Respondent.

and

W. JAMES PRICE, et al.
Petitioners,

v.

MONROE GUTTMANN, LORETTA GUTTMANN,
JANET REES and EVELYN BITTNER,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

I. WHETHER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 IMPOSES ANY DUTIES TO HOLDERS OF CONVERTIBLE DEBENTURES WHICH ARE MORE EXTENSIVE THAN THE DUTIES ESTABLISHED BY THE TERMS OF THE TRUST INDENTURE PERTAINING TO THE DEBENTURES?

II. WHETHER DIRECTORS OF A CORPORATION CAN BE LIABLE UNDER SECTION 10(b) AND RULE 10b-5 FOR FAILURE TO GIVE NOTICE OF A DIVIDEND DECLARATION ABSENT PROOF THAT THE DIRECTORS INTENDED TO ACT FRAUDULENTLY?

III. WHETHER THE THIRD CIRCUIT ERRED BOTH SUBSTANTIVELY AND PROCEDURALLY IN REVERSING THE JUDGMENT IN FAVOR OF PETITIONERS ON THE BASIS OF S.E.C. RULE 10b-17 WHERE THAT RULE IS INAPPLICABLE TO THE TRANSACTION IN QUESTION AND WHERE THE PLAINTIFFS FAILED TO ASSERT A THEORY OF LIABILITY UNDER THAT RULE IN THEIR COMPLAINTS, PRE-TRIAL STATEMENT OR AT TRIAL?

PARTIES TO THE PROCEEDINGS BEFORE THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The caption of this Petition shows the names of all parties on whose behalf this Petition is filed. The Baltimore and Ohio Railroad Company, The Chesapeake and Ohio Railway Company and Chessie System, Inc. were also parties to the proceedings before the Third Circuit. A separate Petition for Writ of Certiorari has been filed on behalf of those companies. The petitioning individuals do not believe that Supreme Court Rule 28.1 is applicable to them, however, the following information is provided as to the corporate co-petitioners:

1. On November 1, 1980, Chessie System, Inc. merged with a corporation named Seaboard Coastline Industries, Inc. to form a new corporation, CSX Corporation.

2. Following the merger, Chessie System, Inc. ceased to exist as a corporate entity.

3. The Chesapeake and Ohio Railway Company is now a wholly owned subsidiary of CSX Corporation.

4. The Baltimore and Ohio Railroad Company is more than 90% owned by the Chesapeake and Ohio Railway Company.

Dr. Milton S. Eisenhower was also a party to the proceedings before the Third Circuit, however, this Petition is not filed on his behalf.

TABLE OF CONTENTS

PAGE

Questions Presented i

Parties to the Proceedings in the Court Below ii

Table of Contents iii

Table of Authorities iv

Opinions Below 1

Jurisdictional Grounds 2

Statutes and Regulations Involved 2

Statement of the Case 4

Basis of Jurisdiction in the District Court 11

Argument 12

I. Compliance with the terms of the Trust Indenture pertaining to plaintiffs' debentures conclusively establishes that petitioners fulfilled any fiduciary duty which may have been owed to the plaintiffs. 12

II. The Third Circuit's reversal of the District Court judgment in favor of the Petitioners was based a fundamental misunderstanding of the "scienter" requirement set forth in *Ernst & Ernst v. Hochfelder.* 14

III. The Third Circuit erred both substantively and procedurally in predicating liability on violation of a duty purportedly owed by Petitioners under S.E.C. Rule 10b-17. 17

Certificate of Filing Pursuant to Supreme Court Rule 28.2 20

Certificate of Service 21

Appendix A

Opinions of the United States Court of Appeals for the Third Circuit rendered upon entry of the judgment of that court. 12

Appendix B

Opinion and Order of the United States District Court for the Western District of Pennsylvania granting judgment in favor of Petitioners 49a

PAGE

Appendix C
Judgment Order of the United States Court of Appeals for the Third Circuit 87a

Appendix D
Order of the United States Court Appeals for the Third Circuit denying Petitioners' Petition for Rehearing 89a

Appendix E
Verbatim text of 17 Code of Federal Regulations 240.10b-17 .... 91a

TABLE OF AUTHORITIES

Cases

Aaron v. Securities and Exchange Commission 446 U.S. 680 (1980) 14

Broad v. Rockwell International Corp., 614 F.2d 418 (5th Cir. 1981), vacated on rehearing *en banc* 642 F.2d 929 (5th Cir. 1981), *cert. denied* __ U. S. ___, 102 S.Ct. 506 (1981) 13

Chiarella v. United States, 445 U.S. 222 (1980) . . . 12, 17

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) . 14, 16, 18

Lutgert v. Vanderbilt Bank, 408 F.2d 1035 (5th Cir. 1975) 18

McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979) 14

Price v. Inland Oil Co., 646 F.2d 90 (3d Cir. 1981) 18

Statutes and Regulations

Securities Exchange Act of 1934, Section 10(b), 48 Stat. 891, 15 U.S.C. §78j(b) .... passim

17 Code of Federal Regulations 240.10b-5 ..... passim

17 Code of Federal Regulations 240.10b-17 17-19

OPINIONS BELOW

The opinions of the United States Court of Appeals for the Third Circuit rendered upon the judgment of the Court are reported at 680 F.2d 933 (1982) and at C.C.H. Fed. Sec. Law Rep. ¶98706

The opinion of the United States District Court for the Western District of Pennsylvania rendered on the judgment of that Court is reported at 509 F.Supp. 1002 (1981) and at C.C.H. Fed. Sec. Law Rep. ¶98440

The opinion of the United States Court of Appeals for the Third Circuit rendered on its order reversing the preliminary injunction issued in these actions is reported at 578 F.2d 1375 (1978).

The opinion of the United States District Court for the Western District of Pennsylvania rendered on its order granting a preliminary injunction in these actions is reported at 444 F.Supp. 656 (1978).

JURISDICTIONAL GROUNDS

This Petition seeks a writ of certiorari to the United States Court of Appeal for the Third Circuit with respect to the judgment of that court entered on June 3, 1982. Petitioners' Petition for Rehearing was denied by the Circuit Court of Appeals by Order dated July 8, 1982. This Court has jurisdiction to review the judgment on writ of certiorari by virtue of 28 U.S.C. §1254.

STATUTES AND REGULATIONS INVOLVED

15 U.S.C. §78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

17 C.F.R. §240.10b-5

Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Verbatim text of 17 C.F.R. §240.10b-17 appears as Appendix E.

STATEMENT OF THE CASE

A. History of the Litigation

This Petition arises from actions brought by holders of Baltimore and Ohio Railroad Company ("B & O") Convertible 4½% Debentures, Series A, maturing January 1, 2010 ("Debentures")[1]. The actions allege violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by the Securities Exchange Commission ("SEC") and assert various pendent claims.

Plaintiff Pittsburgh Terminal Corporation ("Pittsburgh Terminal") is a Pennsylvania corporation, solely owned by plaintiffs Monroe Guttmann and Loretta Guttmann. On December 28, 1977, Pittsburgh Terminal, as a holder of $94,000 in face amount of Debentures, brought an action for a preliminary injunction to enjoin the B & O, The Chesapeake and Ohio Railway Company ("C & O") and Chessie System, Inc. ("Chessie") from paying to the B & O's shareholders a dividend in the form of stock of a B & O wholly-owned subsidiary, Mid-Allegheny Corporation ("MAC"). Declaration of the dividend had been approved at the B & O board of directors' meeting on December 13, 1977. The District Court granted the motion for preliminary injunction on March 7, 1978. The defendants appealed to the United States Court of Appeals for the Third Circuit and on July 5, 1978, that Court reversed and remanded the case to the District Court based on assurances by defendants' counsel as to the availability of sufficient shares of MAC stock should plaintiffs prevail on merits of their claim. 578 F.2d 1375 (3d Cir. 1978).

---

[1] These Debentures are in the face value of $1,000 and before maturity each is convertible into 10 shares of B & O common stock.

On January 22, 1979, plaintiffs Monroe Guttmann, Loretta Guttmann, Janet Rees and Evelyn Bittner brought an action as debentureholders against the B & O, C & O, Chessie and the directors of the B & O, also complaining of the MAC dividend. Pittsburgh Terminal, on February 15, 1979, filed an amended complaint almost identical with the Guttmann complaint. This amended complaint added the directors of the B & O as defendants.

Following extensive discovery, this matter was heard by the District Court sitting without a jury on July 21-24, 1980. On March 10, 1981, the District Court entered judgment in favor of all defendants and dismissed the complaint. 509 F. Supp. 1002 (W.D. Pa. 1981). The District Court found as facts that the B & O directors did not intend to defraud plaintiffs and that their conduct did not constitute an extreme departure from the standard of ordinary care. (The District Court also found that Milton S. Eisenhower was not present at and did not participate in the December 13, 1977 action of the board of directors.) The District Court held as a conclusion of law that plaintiffs failed to prove the requisite scienter to establish a violation of §10(b) and Rule 10b-5. Additionally, the District Court held that a provision of the Trust Indenture pertaining to the plaintiffs' debentures which required ten days notice of "stock" dividends applied only to dividends of B & O shares and did not apply to the dividend of MAC shares.

Plaintiffs took an appeal from the March 10, 1981 order to the United States Court of Appeals for the Third Circuit. (No appeal was taken from the District Court's June 15, 1980 order granting summary judgment in favor of B & O directors Nicholas Camicia, Steven Muller and Cyrus S. Eaton.) The S.E.C. participated in the appeal as *amicus curiae* in support of certain of the plaintiffs' contentions. On June 3, 1982 a three judge panel of the Third Circuit, The Honorable Arlin M. Adams dissenting, reversed the judgment of the District Court (except as to director Milton D. Eisenhower) and remanded the actions for a determination of appropriate relief. The B & O directors' timely petition for rehearing was denied by order dated July 8, 1982. This petition for a writ of certiorari was filed on October 6, 1982 pursuant to Supreme Court Rule 28.2. A separate petition for a writ of certiorari has been filed on behalf of the B & O, C & O and Chessie.

B. Factual Background

The petitioning individual defendants are W. James Price, Alonzo G. Decker, Jr., James Parker Nolan, Frederick Deane, Jr., James L. O'Keefe, Gregory S. DeVine, Fay A. LeFevre, John K. Stevenson, Hays T. Watkins and Howard E. Simpson. All these individuals were directors of the B & O as of December 13, 1977. These individuals are outside directors not employed by the B & O with the exception of Mr. Hays Watkins.

Mr. Watkins was President of The Baltimore and Ohio Railroad Company at all times pertinent to the present actions. At his direction a corporate restructuring committee of B & O officers and employees was formed in late 1976. No directors were on this committee. In December, 1977, approximately 99.63 percent of the outstanding shares of B & O common stock were controlled by the C & O. There were thirteen other shareholders. The C & O was a wholly owned subsidiary of Chessie System, Inc.

The purpose of restructuring the B & O was to provide for the more efficient management and utilization of

B & O assets to the benefit of its shareholders. To that end the restructuring committee sought to segregate non-rail, real property held by the B & O into a separate corporate entity in instances where that could be done without undue expense. The principal benefits of segregation lay in grouping non-rail properties within a corporate entity whose management had special expertise in utilizing such properties, and in eliminating the need to obtain Interstate Commerce Commission approval of decisions affecting those properties.

Similar restructuring via segregation of non-rail assets had been achieved previously by the C & O, as well as by numerous other major railroad companies. In order to remove non-rail assets from jurisdiction of the Interstate Commerce Commission it was necessary that control of the corporation owning the assets, as well as the assets themselves, be removed from the B & O. This was accomplished by transferring the assets to a subsidiary corporation (M.A.C.) and then declaring a dividend of all shares of that subsidiary to shareholders of the B & O. The major shareholder, the C & O, being itself subject to I.C.C. jurisdiction also had to dividend the shares to its parent corporation, Chessie System, Inc.

The dividends in question were declared essentially simultaneously with the transfer of B & O non-rail assets to its subsidiary, Mid-Allegheny Corporation. The declaration and record date for this dividend were identical. This procedure is specifically authorized by the governing Maryland corporate law. Had the number of shareholders of common stock increased beyond fourteen as of December 13, 1977, a registration statement would have had to have been prepared with respect to the dividend. Preparation of a registration statement would have been both expensive and very time consuming due to the number and size of the properties involved and the lack of recent appraisals. Indeed the method of effecting the restructuring through sales of the B & O non-rail assets to Chessie System, Inc. had been rejected based largely on the difficulty of obtaining current appraisals and the possibility of complaints by minority shareholders as to inadequate consideration. The restructuring plan implemented by the asset transfer and dividend method protected B & O minority shareholders by preserving their proportionate interest in the transferred assets. The directors were so advised.

The B & O directors were informed of the essential purposes of management's complex restructuring program and kept advised as to its general progress during the year of 1977. In November, 1977, a six page memorandum outlining the proposed restructuring was supplied to the directors. This memorandum stated, *inter alia:*

> BACKGROUND
>
> . . .
>
> The Committee examined the legal viability of and the financial costs involved in transferring non-essential rail assets owned directly or indirectly by a railroad to a non-rail subsidiary of the Chessie System which would devote its primary attention to the management and development of these non-rail assets.
>
> . . .
>
> OTHER CONSIDERATIONS
>
> SECURITIES ACT REQUIREMENTS. The dividend by Western Maryland Railway of the stock of Western Maryland Company will require that the stock be registered under the Securities Acts of 1933 and

> 1934. A prospectus which is required to be approved by the Securities and Exchange Commission prior to the actual distribution of the dividend has been prepared and will be filed with the Commission promptly following the declaration of the dividend.
>
> . . .
>
> The committee has been informed that a "no action" letter can be obtained from the Securities and Exchange Commission to the effect that no registration would be required for the distribution of the stock of Mount Clare Properties, Inc. by B & O. Likewise, a request for the "no action" letter will be filed with the Securities and Exchange Commission promptly following the declaration of the B & O dividend.
>
> OUTSIDE COUNSEL. The entire transaction described herein has been reviewed and approved by Hunton & Williams, Chessie System's outside counsel in Richmond, Virginia. This firm is also assisting Chessie System in complying with the Securities and Exchange Commission registration requirements described above.

(Mid-Allegheny Corporation was substituted for Mount Clare Properties, Inc. in the final version of the restructuring plan.) This memorandum was discussed item by item at the directors November, 1977 meeting.

An additional memorandum dated December 12, 1977 was prepared for Mr. Watkins to assist him in his presentation at the Board of Directors meeting on December 13, 1977. This later memorandum indicated that: "It has been determined that the B & O dividend on the common shares will not result in adverse federal income tax consequences to the minority shareholders and there is no diminution in their ownership interest in B & O assets." The substance of this memorandum was discussed in detail with the other directors by Mr. Watkins.

The status of the convertible debentures had previously been discussed by Mr. Watkins with his chief legal officer, Roland Donnem. Following legal research and independent readings by Mr. Donnem, Robert Hochwarth and John L. Rogers, Jr., three of the B & O's principal legal counsel, Mr. Watkins was advised that no predeclaration notice needed be given to convertible debenture holders under the terms of the Trust Indenture. Mr. Hochwarth also informed Mr. Donnem that the setting of the dividend declaration date as the record date was proper under applicable Maryland law.

At the December 13, 1977 Board of Directors meeting Mr. Donnem advised the directors that no notice to convertible debenture holders was necessary. Several directors specifically inquired as to the fairness of this transaction with respect to minority shareholders and as to whether the restructuring would diminish the security of the obligations owned to bondholders. The directors were assured that the transaction was fair to the minority shareholders and that the security of the bondholders would not be impaired. Following presentation of the restructuring plan, questions to the officers, and discussion by the directors, the directors adopted the various resolutions implementing the restructuring plan, including *inter alia* the dividend declaration of which plaintiffs complain. Plaintiffs failed to produce any evidence that any director intended to deceive, manipulate or defraud the debentureholders of the B & O, or that the directors acted in other than good faith in approving the restructuring program.

BASIS FOR FEDERAL JURISDICTION IN THE DISTRICT COURT

Jurisdiction of the United States District Court for The Western District of Pennsylvania was based on 15 U.S.C. §78aa, 28 U.S.C. §1332 and upon principles of pendent jurisdiction.

ARGUMENT

I. COMPLIANCE WITH THE TERMS OF THE TRUST INDENTURE PERTAINING TO PLAINTIFFS' DEBENTURES CONCLUSIVELY ESTABLISHES THAT PETITIONERS FULFILLED ANY FIDUCIARY DUTY WHICH MAY HAVE BEEN OWED TO THE PLAINTIFFS.

There can be no liability under §10(b) of the Securities Exchange Act of 1934 absent a breach of a duty owed to the complaining party. *Chiarella v. United States*, 445 U.S. 222 (1980). Additionally, the Court of Appeals for the Fifth Circuit has held that, in the case of convertible debentures, compliance with the terms of the trust indenture conclusively establishes the fulfillment of any and all fiduciary duties to the debentureholders for the purposes of a claim under §10(b):

> "While courts have recognized these [fiduciary] obligations, they have also rejected attempts to expand specific contractual rights to hold that a corporate defendant or a controlling shareholder had a "duty" to the plaintiff that extended beyond performance of the contract. [Citations omitted] Where the defendant had fully complied with the contract, he had discharged his obligation.
>
> We think a similar view is appropriate in this case. If the jury finds that Rockwell fully complied with the terms of the debenture agreement then the fiduciary duty claim should not be reached. Rockwell's duty to the debentureholders was to see that they were treated fairly and that they received what they were entitled under the agreement. Finding that the contract's terms were fully complied with is conclusive demonstration that Rockwell performed its duty."

> *Broad v. Rockwell International Corp.*, 614 F.2d 418, 431 (5th Cir. 1981).

The full court held that, assuming the correctness of the panel's analysis, the terms of the indenture had been complied with as a matter of law. *Broad v. Rockwell International Corp.*, 642 F.2d 929, 958-959 (5th Cir. 1981), *cert. denied* 102 S.Ct. 506 (1980).

The relevant provision of the Trust Indenture in the present actions reads as follows:

> Section 12. The Company covenants and agrees that it will not declare and/or pay any dividend on its common stock payable in stock or create any rights to subscribe for stock or securities convertible into stock unless in any such case notice of the taking of a record date for the determination of the stockholders entitled to receive such dividend, distribution or right is given at least ten days prior thereto by at least one publication in an Authorized Newspaper. A copy of each such published notice shall promptly after such publication be filed with the Trustee.

The District Court held, contrary to the plaintiffs' assertion, that "the word 'stock' in Section 12 referred only to the stock of the B & O and that the payment of a dividend in kind of the stock of another corporation was similar to a cash dividend". Accordingly, the District Court dismissed the plaintiffs' pendent claim for alleged breach of the trust indenture. The Third Circuit's opinion did not reach the issue of whether the terms of the Trust Indenture had been violated. More importantly, the opinion totally ignored the Fifth Circuit's holding in *Broad v. Rockwell International Corp., supra.* Circuit Judge Adams's dissenting opinion, however, followed the *Broad* analysis in concluding that "under well-established common law principles [plaintiffs] have no right—unless otherwise specified in the debenture—to notice of corporate actions that may affect the value of the conversion option." 680 F.2d 954. A writ of certiorari should be granted to resolve the conflict between the Third Circuit and Fifth Circuit as to the effect of compliance with the terms of a debenture on the rights of convertible debentureholders to recover for alleged breaches of §10(b) of the Securities Exchange Act of 1934.

II. THE THIRD CIRCUIT'S REVERSAL OF THE DISTRICT COURT JUDGMENT IN FAVOR OF THE PETITIONERS WAS BASED A FUNDAMENTAL MISUNDERSTANDING OF THE "SCIENTER" REQUIREMENT SET FORTH IN ERNST & ERNST V. HOCHFELDER.

Scienter is an essential element of a cause of action alleging violation of §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b). This is so both in private damage actions, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) and enforcement actions by the S.E.C., *Aaron v. Securities and Exchange Commission*, 446 U.S. 680 (1980). Plaintiff has the burden of proving scienter. *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979). The District Court held as a conclusion of law that "[p]laintiffs failed to establish that the defendant directors had the requisite scienter to establish a violation of Section 10(b) and Rule 10b-5." This holding followed from the District Court's findings of fact that "the directors of the B & O did not intend to defraud plaintiffs" and that "the conduct of the directors of the B & O did not constitute an extreme departure from the standard of ordinary care."

In making these findings the District Court accepted testimony offered on behalf of the defendants that the timing of the complained of dividend declaration was adopted for the legitimate business purpose of implementing the corporate restructuring plan with a minimum of expense and delay, and that in so acting the board of directors had been advised by legal counsel that no notice of the dividend declaration need be given convertible debentureholders. Similarly, the District Court's findings were supported by the November, 1977 memorandum to the directors indicating that the entire restructuring transaction had been reviewed and approved by outside counsel. Based on this evidence and on the plaintiffs' failure to introduce any evidence showing that the directors intended to defraud the plaintiffs the District Court's Findings of Fact were not "clearly erroneous" within the meaning of Fed. R.Civ.P. 52.

The Third Circuit opinion announcing the judgment the court did not purport to reject the District Court's findings of fact as clearly erroneous. Instead, the Third Circuit in effect held that the District Court had applied a legally incorrect analysis of scienter, stating: "The decision to time the MAC transaction so as to prevent notice to the bondholders until too late was both knowing and intentional. No more is required by the governing cases." 680 F.2d 942.[2] Petitioners maintain that "more" was indeed required and that plaintiffs failed to supply it.

---

[2] This description of the petitioners' conduct constitutes a crucial mischaracterization suggesting bad faith on the directors' part. The directors did not "prevent notice". They set the declaration and record date for the dividend on the same day (as specifically authorized by Maryland corporate law) after being advised by legal counsel that there was no duty to provide advance notice to the debentureholders and after receiving assurances as to the propriety of the transaction under the securities law generally.

In landmark decision of *Ernst & Ernst v. Hochfelder, supra*, this Court stated:

> "We granted certiorari to resolve the question whether a private cause of action for damages will lie under §10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud.[12] . . . we conclude that it will not and therefore we reverse." 425 U.S. 193

In footnote twelve the Court specified:

> "In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. 193

In reaching its conclusion and in utilizing the definition set forth above this Court examined both the language and legislative history of §10(b). "The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that §10(b) was intended to proscribe knowing or intentional misconduct." 425 U.S. 197. The preceding sentence must be read as a whole, i.e. §10(b) is directed at "knowing misconduct" not merely knowing conduct: "There is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catchall provision of Section 10(b) should be interpreted no more broadly." *Ernst & Ernst v. Hochfelder*, 425 U.S. 206. This language sustains the District Court's view that a "plan to deceive" or "intent to defraud" is required for liability to exist under §10(b) of the Securities Exchange Act of 1934. A writ of certiorari should be granted to insure correct application of the important principles enunciated in *Ernst & Ernst v. Hochfelder.*

III. THE THIRD CIRCUIT ERRED BOTH SUBSTANTIVELY AND PROCEDURALLY IN PREDICATING LIABILITY ON VIOLATION OF A DUTY PURPORTEDLY OWED BY PETITIONERS UNDER S.E.C. RULE 10b-17.

The Third Circuit's opinion announcing the judgment of the court posited four separate sources of the duty required by *Chiarella v. United States*, 445 U.S. 222 (1980). Petitioners dispute that opinion's analysis of their alleged duties under each of the four sources. The Third Circuit's holding, however, is limited by the terms of Circuit Judge Garth's concurrence to the position that all of the defendants (including the petitioning directors) owed plaintiffs a duty by virtue of S.E.C. Rule 10b-17. The Third Circuit's reliance on that Rule was erronous for several reasons. Rule 10b-17 states in relevant part:

> (a) It shall constitute a "manipulative or deceptive devise or contrivance" as used in section 10(b) of the Act for any *issuer* of a class of securities . . . to fail to give notice in accordance with paragraph (b) of this section of the following actions relating to such class of securities:
>
> > (1) A dividend or other distribution in cash or in kind, except an ordinary interest payment on a debt security, but including a dividend or distribution of any security of the same or another issuer;
> >
> > . . .
>
> (b) Notice shall be deemed to have been given in accordance with this section only if:
>
> > (1) Given to the National Association of Securities Dealers, Inc., no later than ten days prior to the record date involved . . . (emphasis added).

The Third Circuit's holding that Rule 10b-17 imposes a duty on an issuer of securities and its board of directors to provide notice as required by the Rule and that failure to provide such notice gives rise to civil liability under §10(b) breaks new legal ground. This holding is highly suspect since, as set forth in Part II of Circuit Judge Adams's dissenting opinion, Rule 10b-17 was not intended to provide debentureholders with substantive rights outside the scope of the indenture and the MAC dividend does not "relate to" the plaintiffs' debentures within the meaning of the Rule. Additionally, even if the Rule were generally applicable to the present actions, Rule 10b-17 by its terms applies to the "issuer" of a security and is not a proper basis on which to predicate liability of the individual directors of the B & O. Only one prior case has ever discussed the scope of Rule 10b-17, *Lutgert v. Vanderbilt Bank*, 508 F.2d 1035 (5th Cir. 1975). The discussion in that case, which in itself was dictum, does not encompass the facts of the present actions. 508 F.2d 1038-1039.

Furthermore, the Third Circuit's reliance on Rule 10b-17 was improper from a procedural standpoint. The existence and breach of a duty under the Rule was never pleaded in plaintiffs' complaints, amended complaints or pre-trial statement, nor was the issue raised at trial. Thus, any issue as to the applicability of Rule 10b-17 was waived by the plaintiffs under well-established principles followed by both the Third Circuit and this Court. *Price v. Inland Oil Company*, 646 F.2d 90 (3d Cir. 1981), *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976):

> Respondents further contend that *Ernst & Ernst* owed them a direct duty under §17(a) of the 1934 Act and Rule 17a-5 to conduct a proper audit of First Securities and that they may base a private cause of

> action against *Ernst & Ernst* for violation of that duty. Respondents' cause of action, however, was premised solely only the alleged violation of Section 10(b) and Rule 10b-5. During the lengthy history of this litigation they have not amended their original complaint to aver a cause of action under §17(a) and Rule 17a-5. We therefore do not consider that a claim of liability under §17a is properly before us even assuming respondents could assert such a claim independently of Section 10(b). 425 U.S. 194 at n.13.

The Third Circuit's reliance on Rule 10b-17 conflicts not only with principles designed to insure orderly regulation of appellate practice, but also effectively deprived petitioners of their due process right to be heard on the issue upon which that court predicated liability. For these reasons, and because the Third Circuit's substantive holding on this issue was in error a writ of certiorari should be granted.

Respectfully submitted,

SHARLOCK, REPCHECK, ENGEL &
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CERTIFICATE OF FILING PURSUANT TO SUPREME COURT RULE 28.2

The undersigned, who is a member of the Bar of this Court, hereby certifies under oath that forty (40) copies of the within Petition for Writ of Certiorari were filed by depositing them at the United States Post Office, Grant Street, Pittsburgh, Pennsylvania 15219 with first class postage prepaid on October 6, 1982.

SHARLOCK, REPCHECK, ENGEL & MAHLER

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(A notarized duplicate of this certificate has been separately filed with the Court.)

CERTIFICATE OF SERVICE

The undersigned, who is a member of the Bar of this Court, hereby certifies that three copies of the within Petition for Writ of Certiorari were served upon the following individuals at the addresses shown below by first class United States Mail, postage prepaid on October 6, 1982:

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APPENDIX

Appendix A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-1674

PITTSBURGH TERMINAL CORPORATION,
Appellant
v.
THE BALTIMORE AND OHIO RAILROAD COMPANY, et al.,
Appellees
(D.C. Civil No. 77-1455)

No. 81-1675

MONROE GUTTMANN, LORETTA GUTTMANN,
JANET REES and EVELYN BITTNER,
Appellants
v.
THE BALTIMORE AND OHIO RAILROAD COMPANY, et al.,
Appellees
(D.C. Civil No. 79-0094)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Argued: December 16, 1981
Before: ADAMS, GIBBONS and GARTH, *Circuit Judges*
(Opinion Filed: June 3, 1982)

OPINION ANNOUNCING THE JUDGMENT OF THE COURT

GIBBONS, *Circuit Judge.*

Pittsburgh Terminal Corporation, Monroe Guttmann, Loretta Guttmann, Evelyn Bittner and Janet Rees (the Bondholders), holders, prior to December 13, 1977, of convertible debentures issued by The Baltimore and Ohio Railroad Company (B & O), appeal from a final judgment dismissing their complaint, which charged that a dividend by the B & O on that date of stock of Mid-Allegheny Corporation (MAC) to B & O stockholders of record on that date violated the federal securities laws and the laws of several states. The defendants are B & O, a Maryland corporation, The Chesapeake & Ohio Railway Company (C & O), a Virginia corporation which on December 13, 1977, owned more than 99% of B & O's common stock, Chessie System, Inc. (Chessie), a Virginia corporation which is a holding company for C & O and its subsidiaries, and fourteen present or former directors of B & O. The convertible debentures owned by the Bondholders are B & O Series A, dated January 1, 1956 and maturing January 1, 2010, paying interest at 4.5%, and convertible at any time before maturity into 10 shares of B & O common stock for each $1000 of face value. The action of which the Bondholders complain is the action of the defendants in fixing December 13, 1977, as both the date of declaration of, and the record date for participation in, the in kind dividend of MAC stock to B & O common stockholders. That action deprived debenture holders of the opportunity to convert before the record date and thereby participate in the dividend. The District Court held that it violated no legally protected rights of the debenture holders.[1] We reverse.

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[1] The District Court decision is reported. Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 509 F.Supp. 1002 (W.D. Pa. 1981).

I.

B & O owns and operates a railroad regulated by the Interstate Commerce Commission (ICC). Prior to the transactions giving rise to this lawsuit, B & O also owned substantial non-rail assets such as real estate, timber and mineral reserves. At one time both its common stock and its debentures were traded on the New York Stock Exchange (NYSE). When C & O acquired 99.63% of B & O's common stock, trading in that security ceased and it was delisted, although 13 individuals still held some shares. The NYSE listing of B & O's convertible debentures continued. No dividends were paid on the B & O common stock after 1961. Thus the holders of convertible debentures had no particular incentive to exercise the conversion privilege unless the no dividend policy were to change.

Because the regulations of the ICC prohibited a railroad corporation from engaging in non-rail business, B & O's and C & O's assets not used in rail transportation remained undeveloped. Beginning in 1973 when Chessie was formed, C & O began segregating its non-rail assets in a separate corporation, Chessie Resources, Inc., so that they could be developed free of constraints imposed by the ICC. The Chessie management desired to accomplish the same result with respect to B & O's non-rail assets. To that end, in January of 1977, the Chessie Corporation Restructuring Committee settled on a plan whereby the B & O would transfer those assets to MAC, a wholly owned B & O subsidiary, and then distribute the MAC stock as a dividend to B & O's fourteen common stockholders.

If, prior to the dividend in MAC stock, the number of B & O common stockholders were to increase substantially, B & O might have had to file a registration statement for MAC with the Securities and Exchange Commission (SEC). 15 U.S.C. §77f (1976). There were practical difficulties with the preparation of a registration statement, especially that of placing a value on B & O's non-rail assets. But if notice of the MAC transaction had been given to the convertible debenture holders prior to the record date of the in kind dividend, many of them might have elected to convert. Thus the Restructuring Committee concluded that the MAC transaction should be structured in such a way that the convertible debenture holders would not have such notice until after the record date. This, it was thought, would permit counsel for B & O to obtain from the SEC a no-action letter with respect to registration of the MAC stock.

At the time the MAC transaction was under consideration, B & O had outstanding bond obligations under three trust indentures. One of these, a Convertible Income Bond Debenture, contained a provision requiring B & O to pay into a surplus income sinking fund an amount equal to any dividend. A second, the Refunding and General Mortgage Indenture, required that arrearages in the sinking funds had to be made up before a dividend could be paid. It was these provisions which had prevented B & O from paying dividends since 1961. The third Indenture was that governing the convertible debentures held by the Bondholders. In order to facilitate the dividend in MAC stock, B & O called for redemption the Convertible Income Bonds, and discharged the sinking fund arrearages on the Refunding and General Mortgage Indenture by paying the sinking funds approximately $7,000,000. These steps were accomplished by the summer of 1977. The Restructuring Committee then turned to the Indenture for the convertible debentures.

The convertible debentures also contained a redemption feature which in 1977 called for payment of a premium of 2.5% of their face amount. (344a). B & O did not elect to redeem. Conversion privilege features of the indenture oblige B & O to reserve sufficient common stock and to adjust for changes in par value. (350a). Conversion rights to the bondholders are protected in the event of merger or sale. (354a). Article V, Section 12 of the Indenture provides:

> SECTION 12. The Company covenants and agrees that it will not declare and/or pay any dividend on its common stock payable in stock or create any rights to subscribe for stock or securities convertible into stock unless in any such case notice of the taking of a record date for the determination of the stockholders entitled to receive such dividend, distribution or right is given at least ten days prior thereto by at least one publication in an Authorized Newspaper. A copy of each such published notice shall promptly after such publication be filed with the Trustee.

(357a). When the convertible debentures were issued in 1956, B & O entered into a listing agreement with the NYSE relating to them, which incorporated by reference B & O's earlier listing agreements. Listing Agreement A-12653 for an earlier bond issue, incorporated by reference in that for the 1956 convertible debenture issue, provides:

> 4. The Corporation will give the Exchange at least ten days' notice in advance of the closing of the transfer books, or of the taking of a record of its stockholders for any purpose.
>
> 5. The Corporation will publish promptly to the holders of any of its securities listed on the

> Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and shall give prompt notice to the Exchange of any such action; and shall afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights; and shall issue all such rights in form approved by the Exchange and will make the same transferable, payable and deliverable in the Borough of Manhattan, in the City of New York.

(455a). In addition to the Listing Agreements, the B & O is bound by the Rules of the NYSE. Section A-2 of its Manual, "Timely Disclosure," provides:

> A corporation whose securities are listed on the New York Stock Exchange, Inc., is expected to release to the public any news or information which might reasonably be expected to materially affect the market for those securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the exchange.

509 F.Supp. at 1008.

In November of 1977, by which time impediments to the payment of dividends on B & O stock in the Convertible Income Bond Debenture and the Refunding and General Mortgage Indenture had been removed, plaintiff Monroe Guttmann wrote to the Secretary of B & O:

> As one of the very few public owners of B & O common stock, we are concerned that we may not be made aware of any dividend the directors declare on

> the common stock in sufficient time to convert any of our convertible debentures.
>
> Although it may not be customary to do so in view of the fact that declaration of a dividend may not be widely publicized, if publicized at all, we ask that you notify us promptly of any such dividend declaration so that we will have an opportunity to convert debentures in time to receive such dividend if we choose to do so.
>
> Will you please let me know what provisions there are in the by-laws of the company that govern the time which must elapse between the declaration of a dividend, the record date and the payable date.

(311a). To this pointed inquiry the Secretary, on November 17, 1977, replied:

> Thank you for your letter of November 11. We appreciate your concern as a holder of B & O Convertible Debentures as to whether B & O would fail to disclose the declaration of a dividend in its common stock.
>
> You may be assured that if B & O should have any information to announce regarding dividend action on B & O stock, such information will be disseminated promptly to the public at large. Because we cannot prefer you over the public at large advance advice cannot be sent to you, but I will make sure that you get a copy of such press release. We are not in a position to help you with respect to your decision whether or not to convert.
>
> There is no by-law provision relating to the timing of the declaration, record, and payment dates.

(312a). By the time of Guttmann's inquiry and the Secretary's reply, the Restructuring Committee's plan to structure the MAC transaction so as to avoid timely notice to the convertible bondholders was well advanced.

Four in-house attorneys employed by B & O or C & O, one of whom was Chairman of the Restructuring Committee, examined the 1956 indenture and the New York Stock Exchange listing agreements. They concluded that the indenture required notice of stock dividends in B & O stock, but not of distributions of stock of subsidiaries. They concluded that that provision in the New York Stock Exchange listing agreement was inapplicable because it requires 10 days notice only with regard to dividends declared on listed stocks, and B & O common stock had been delisted. They concluded that under Maryland law absent any action by the directors, the payment date of a dividend could be the same as the declaration date. The Restructuring Committee determined, therefore, to avoid giving notice to the convertible debenture holders. Their purpose in doing so was to prevent conversions which might require filing a registration statement for MAC stock.

The General Counsel of B & O retained the law firm of Hunton & Williams of Richmond, Virginia, to submit to the SEC a request for a no-action letter with respect to B & O's distribution of MAC shares. Prior to the time Hunton & Williams wrote to the SEC, the B & O Board of Directors met and adopted two resolutions. In the first resolution the Board authorized B & O's officers to convey a list of non-rail assets to MAC as a contribution to its capital. (409a). In the second, the Board resolved to distribute the MAC stock as a dividend to B & O shareholders. That resolution provides in part:

> RESOLVED, that the dividend on the Common Stock as specified in the next preceding resolution be payable on this date to shareholders of record at the

> close of business on this date; provided, however, that such payment shall be made by depositing such stock of Mid Allegheny Corporation with Mercantile Safe Deposit and Trust Company of Baltimore, Maryland, in trust, to be delivered to such shareholders of this Company on the earlier of the following dates, viz.: two days following the receipt of a letter from the Securities and Exchange Commission that it will take no action if the stock of Mid Allegheny Corporation is distributed to this Company's shareholders without registration under the provisions of the Securities Act of 1933; or two days following the date of an effective registration statement with respect to the stock of Mid Allegheny Corporation.

(417a). Thus actual delivery of the MAC stock certificates to shareholders was made contingent upon the obtaining of a no-action letter or the filing of a registration statement. It seems clear from the wording of the resolution that B & O intended to file a registration statement if it could not obtain a no action letter, for the dividend declaration is unconditional.

Three days after B & O's dividend action, Hunton & Williams sent a request for a no-action letter to the SEC. (908a). That firm's December 16 letter to the Commission requested a no-action letter only with respect to a distribution of MAC stock to C & O and 13 individual B & O stockholder. It made no mention of the rights of convertible debenture holders. In its request Hunton & Williams opined that the distribution of MAC shares by B & O was not a sale within the meaning of Section 2(3) of the Securities Act of 1933, 15 U.S.C. §77b(3). Alternatively the firm suggested that if a sale were involved, the transaction was exempt under 17 C.F.R. §230.240 (1981). That SEC rule, issued pursuant to Section 3(b), 15 U.S.C.

§77c(b), exempts from registration certain securities of an issuer to fewer than 100 persons, provided that restrictions on transferability are legended on the certificates. The no-action letter was not immediately forthcoming from the SEC, and on January 18, 1978, Hunton & Williams withdrew its reliance on 17 C.F.R. §230.240. (914a). Another written request was filed on June 29, 1979, relying solely on the contention that the dividend in MAC stock was not a sale. (915a). In September of 1979, long after the commencement of this lawsuit, the SEC issued a no-action letter "provided that MAC shares distributed to persons other than C & O are restricted as to transfer." The SEC letter noted that the District Court had by then entered an order that the defendants must hold at least 940 shares of MAC for tender to the convertible debenture holders if they prevailed. (919a).

II.

The first of these consolidated actions was commenced by Pittsburgh Terminal Corporation on December 28, 1977, and the others soon followed. On March 7, 1978 the District Court issued a preliminary injunction restraining the defendants from proceeding with the dividend in MAC stock.[2] Defendants appealed from that order, and when they agreed to hold sufficient shares of B & O and MAC stock to satisfy the claims of the convertible debenture holders, should they prevail, this court reversed that injunction.[3] The Bondholders sought class action certification, which was denied as a result of an agreement between B & O and the Trustee under the 1956 indenture that should plaintiffs prevail, all debenture holders similarly situated will be accorded the treatment required by any judgment in plaintiffs' favor.[4] Motions for summary judgment in favor of the defendants were denied.[5] Thus the consolidated cases went to trial on amended complaints challenging the December 13, 1977 actions of the B & O Board of Directors. The complaints alleged that those actions violated Section 10(b) of the Securities and Exchange Act, 15 U.S.C. §78j(b), the contractual rights of the convertible debenture holders under the provisions of the Indenture, their rights as third party beneficiaries of the NYSE listing agreements, the obligations of B & O under the rules of the NYSE, and the fiduciary duties of directors and of majority stockholders under Maryland law. The District Court, over defendants' objection, held that the convertible debenture holders had standing to make these claims, but rejected each of them. The court held that there was an insufficient showing of scienter for a Section 10(b) violation; that Section 6 of the Securities and Exchange Act of 1934, 15 U.S.C. §78f, does not permit private enforcement of the NYSE rules; that the listing agreements confer no rights on any party other than the NYSE; that the indenture does not require notice of a dividend in stock of a subsidiary; and that the December 13, 1977

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[2] 446 F.Supp. 656 (W.D. Pa. 1978).

[3] Unpublished per curiam noted at 578 F.2d 1375 (3d Cir. 1978).

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[4] 509 F.Supp. at 1009.

[5] Summary judgment was granted in favor of three directors, Stephen Muller, Nicholas T. Camicia and Cyrus S. Eaton, who did not participate in the December 13 Board actions. 509 F.Supp. at 1004. That ruling is not appealed.

MAC transactions were entirely legal under Maryland law.[6] Without ruling definitively, the court also expressed doubts about what relief would be proper assuming liability had been established.

III.

A. *Purchase or Sale*

SECTION 10(b) prohibits the use of manipulative or deceptive devices or contrivances "in connection with the purchase or sale of any security." The District Court held that a contract to obtain common stock in exchange for the surrender of a convertible debenture is a contract for purchase or sale of a security, and thus that the debenture holders could sue. Defendants challenge that holding. They place principal reliance upon *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). That case approved the earlier holding in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), that only purchasers and sellers of securities could bring a private damage action under Section 10(b). While *Blue Chip Stamps v. Manor Drug Stores* holds that mere offerees may not sue under Section 10(b), the opinion of the Court carefully distinguishes the case of persons holding actual contractual rights to buy and sell securities. 421 U.S. at 749-50. There is no indication that the Court intended to cast any doubt on the settled rule that a contract to buy or sell securities is a purchase or sale within the meaning of Section 10(b), and that a party to such a contract has standing to sue for damages.[7] The indication is quite the contrary, for the Court observed:

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[6] The court also dismissed Milton S. Eisenhower as a defendant because he did not participate in the December 13, 1977 Board meeting. 509 F.Supp. at 1018.

> Unlike respondent, which had no contractual right or duty to purchase Blue Chip's securities, the holders of puts, calls, options and other contractual rights or duties to purchase or sell securities have been recognized as "purchasers" or "sellers" of securities for purposes of Rule 10b-5, not because of a judicial conclusion that they were similarly situated to "purchasers" or "sellers," but because the definitional provision of the 1934 Act themselves grant them such status.

421 U.S. at 751.

Since we hold that the conversion option in a convertible debenture qualifies as a contract for the purchase or sale of a security, we need not reach the plaintiffs' alternative contention that the MAC dividend is a purchase or sale which would satisfy Section 10(b). *See International Controls Corp. v. Vesco*, 490 F.2d 1334, 1345 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974) (a dividend in kind of shares of a spun off corporation qualifies as a sale of securities).

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[7] *See, e.g.*, Internation Controls Corp. v. Vesco, 593 F.2d 166, 181 n.18 (2d Cir.), *cert. denied*, 442 U.S. 941 (1979); Davis v. Davis, 526 F.2d 1286, 1289 & n.4 (5th Cir. 1976); Fenstermacher v. Philadelphia National Bank, 493 F.2d 333, 336 n.4 (3d Cir. 1974); Walling v. Beverly Enterprises, 476 F.2d 393, 396 n.5 (9th Cir. 1973); Green v. Hamilton Intern. Corp., 437 F.Supp. 723, 727 (S.D.N.Y. 1977); Camp v. Genesco, [1976-77] Fed. Sec. L. Rep. (CCH) ¶95,679 at 90,336-37 (S.D.N.Y. 1976). *But cf.* Broad v. Rockwell International Corp., 614 F.2d 418 (5th Cir. 1980). *vacated upon rehearing en banc*, 642 F.2d 929 (5th Cir. 1981), *cert. denied*, 50 U.S.L.W. 3351 (U.S. Nov. 3, 1981). If the vacated panel opinion in *Broad* can be read to suggest that the holder of a debenture containing a conversion option is not a purchaser or seller, we decline to follow it.

B. *Duty to Speak*

The Bondholders contend that by fixing the dividend date and the record date of the MAC dividend so as to prevent them from exercising their conversion option in time to participate in that dividend, the defendants violated Section 10(b) and SEC Rule 10b-5(a) and (c), 17 C.F.R. 204.10b-5(a) and (c) (1981). It is undisputed that the defendants made a knowing decision to time the December 13, 1977 transactions so as to prevent the Bondholders from obtaining timely notice of them. Defendants contend that the decision was lawful because they made no affirmative misrepresentation and because they were under no affirmative obligation to speak.

In *Chiarella v. United States*, 445 U.S. 222, 228 (1980), the Court observed that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so." It held that a printer, who had no fiduciary obligation to a corporation or its shareholders, and who did not receive information as a result of the breach of any fiduciary relationship, could not be liable for a criminal violation of Section 10(b). "He was not [the sellers'] agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence." 445 U.S. at 232. The defendants contend that *Chiarella* requires an affirmance, because like the printer who happened upon material market information, none of them had a duty to speak.

To put that contention in context, we note that the Bondholders were on December 13, 1977, holders of options to acquire B & O equity securities, while C & O was a majority holder of those securities having voting control of B & O. The convertible debentures were listed on the NYSE, and the listing agreement applicable to them imposed on B & O the affirmative duties (a) to give ten days notice to the Exchange of a record date for a dividend, and (b) to "afford the holders of its securities listed on the Exchange a proper period within which to record their interests and exercise their rights." These requirements of the listing agreement parallel those in SEC Rule 10b-17, which provides:

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Act for any issuer of a class of securities . . . to fail to give notice in accordance with paragraph (b) of this section of the following actions relating to such class of securities:
>
> (1) A dividend or other distribution in cash or in kind, except an ordinary interest payment on a debt security, but including a dividend or distribution of any security of the same or another issuer;

17 C.F.R. §240.10b-17 (1981). B & O is the issuer of the convertible debentures, the MAC distribution is a dividend of a security, and that dividend related to the convertible debentures since it was material to a decision about exercising the conversion option. The convertible debentures were not simple debt securities, for which the information about dividends ordinarily would not be material.

Whatever may be the fiduciary duty of majority stockholders and corporate directors under Maryland law to general unsecured creditors, we are here dealing with securities having an equity option feature. Maryland follows the settled rule that a control stockholder owes a fiduciary obligation not to exercise that control to the disadvantage of minority equity participants. *Cooperative Milk Service v. Hepner*, 198 Md. 104, 81 A.2d 219, 224 (1951). Similarly, Maryland directors must act as fiduciaries to all equity participants. *Coffman v. Maryland Pub. Co.*, 167 Md. 275, 173 A.248, 254 (1934); *Lawson v. Baltimore Chemical and Paint Corp.*, 347 F. Supp. 967, 975 (D. Md. 1972). Although no Maryland case has been called to our attention presenting the precise issue of fiduciary obligations to holders of securities containing stock options, we would be very much surprised if Maryland or any other state would today hold that no such obligations were owed by an issuer of such securities and its directors. Moreover the scope of the obligation of the fiduciary depends upon the nature of the interest of the beneficiary. If the beneficiary of a fiduciary duty needs information in order intelligently to protect that interest, the withholding of it, especially when withholding it confers advantage upon others (in this case C & O and Chessie) is an obvious breach of duty.

The 1956 Indenture under which B & O borrowed the sums evidenced by the convertible debentures was made in New York and the loan transaction completed there. B & O's obligation, therefore, is a New York contract. The law of that state is "that in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract. . . . " *Kirke La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933). *See Van Gemert v. Boeing Co.*, 553 F.2d 812, 815 (2d Cir. 1977); Restatement (Second) of Contracts §205 (1981). Defendants in this case took steps to prevent the Bondholders from receiving information which they needed in order to receive the fruits of their conversion option should they choose to exercise it. As a matter of New York contract law, B & O had a duty to speak.

In the present context we do not look to the listing agreement. Rule 10b-17, the Maryland law of fiduciary obligations and the New York law of contracts as sources of independent causes of action, though they well may be. Rather we look to them as sources of a duty to speak, breach of which under Section 10(b) and Rule 10b-5(a) and (c) gives rise to a cause of action for fraud. Those four independent sources of duty to speak in the circumstances of this case amply serve, separately or collectively, to distinguish it from *Chiarella v. United States, supra.* We need not consider other sources of such duty relied on by the Bondholders.

C. *Scienter*

The defendants urge that even if they were under a duty to speak, their decision not to do so in this instance did not involve the scienter required by the Supreme Court's interpretation of Section 10(b). The District Court, relying on *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), accepted this argument. It found that there was a legitimate business purpose in removing the nonrail assets from ownership and control of B & O.[8] That finding is not relevant, however, for what is complained of is not the formation of MAC or the decision to spin it off, but the decision to do both while concealing those steps from the Bondholders until it was too late for them to participate by exercising conversion rights if they chose to do so.

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[8] 509 F.Supp. at 1012-13.

In this record, and indeed in the court's findings of fact, it is plain that the Restructuring Committee and B & O's Directors knew (1) that the information about the dividend in MAC shares, or information about any other dividend action after a lapse of sixteen years, was material to the Bondholders; (2) that cutting off conversion options would inure to the benefit of C & O, the majority stockholder; and (3) that the decision not to announce the dividend was intended to prevent timely exercise of the conversion privilege. The decision to time the MAC transaction so as to prevent notice to the Bondholders until too late was both knowing and intentional. No more is required by the governing cases. *Aaron v. Securities and Exchange Commission*, 446 U.S. 680, 690 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Cramer v. General Telephone & Electronics Corp.*, 582 F.2d 259, 273 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). *Cf. McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979).

The defendants insist that despite their intention to prevent timely exercise of conversion rights prior to the MAC dividend, they lacked the necessary scienter as a matter of law for two reasons. First, they contend, they had a valid business purpose in cutting off conversion rights in that they desired to avoid having to file a registration statement for MAC stock. This is a business reason, certainly, but not a valid one. Of course, the removal of non-rail assets from the reach of the conversion privilege, and the avoidance of the expense of preparing and filing a registration statement, was good business for some of the interested parties. Clearly, however, it was bad business for the Bondholders. Any manipulative act or practice can be justified by focusing only on the business purpose of the side of the transaction which benefited from it.

Defendants' second contention is that their reliance on the advice of counsel employed by B & O and C & O is a complete defense. In this case it is not. A violation of Section 10(b) does not require a specific intention to break the law. It requires only knowing or intentional actions which, objectively examined amount to a violation. *See Securities and Exchange Commission v. Falstaff Brewing Corp.* 629 F.2d 62, 77 (D.C. Cir.), *cert. denied sub nom. Kalmanovitz v. Securities and Exchange Commission*, 449 U.S. 1012 (1980); *Arthur Lipper Corp. v. Securities and Exchange Commission*, 547 F.2d 171, 181 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978). Advice of counsel may bear upon scienter in some cases: where, for example, directors rely upon counsel to conduct a factual investigation of the truth of information to be released; or where counsel mistakenly but in good faith represent that some information is either immaterial or clear. In such instances the defendants may not have an appreciation of the consequences of their conduct. But where, as here, they know the materiality of the concealed information and intend the consequences of concealment, advice of counsel that they will not incur liability cannot be recognized as a defense. The court, not counsel, must make that ultimate legal determination.

On the facts as found, therefore, the District Court erred in ruling that the defendants lacked the scienter required for a Section 10(b) violation.

We hold, therefore, that on the facts found by the District Court, the December 13, 1977 transaction, designed to deprive the Bondholders of timely notice in order to exercise their conversion option if they should so desire was a manipulative or deceptive device or contrivance in violation of Section 10(b).[9]

IV.

Our holding in Part III requires a reversal. The Bondholders also contend that they proved a breach of the Indenture, a claim as a third party beneficiary for breach of the listing agreement and breaches of fiduciary duty under Maryland law. In the District Court they pleaded, as well, a cause of action under Section 6 of the Securities and Exchange Act of 1934, 15 U.S.C. §78f, for violation of the NYSE rules. They do not suggest, however, that the relief available under Section 10(b) is less extensive than would be available under these alternative legal theories. Since it appears that no different remedies would be available were we to decide in the Bondholders' favor on those alternative legal theories, there is no reason to address them.

V.

As a separate ground for affirmance, the defendants urge that the Bondholders failed to prove damages and have not to date exercised their conversion option. Obviously the Bondholders could not be expected to exercise a conversion option until they knew whether or not they were entitled to participate in the distribution of MAC stock. As to the speculative nature of the award of money damages, the difficulty arises out of B & O's conscious choice to avoid making an evaluation of the B & O assets transferred to MAC as a contribution to capital. The District Court speculated that devising an appropriate remedy might be difficult. So it may be, but the Bondholders were the victims of a Section 10(b) violation, and they are entitled to be heard about what the remedy should be. Since the District Court did not rule on the matter of relief, nothing is before us on that aspect of the case which we can intelligently review. A remand is required so that the trial court can fashion an appropriate remedy for the violation we have found.

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[9] The court's finding that Milton E. Eisenhower did not participate in the December 13, 1977 meeting is not clearly erroneous; indeed it is not challenged. Thus the judgment in his favor must be affirmed.

VI.

Except for the judgment in favor of Milton D. Eisenhower, the judgment in favor of the defendants will be reversed, and the case remanded for a determination of appropriate relief.

GARTH, *Circuit Judge*, concurring in part and concurring in the judgment.

I agree that the judgment of the district court must be reversed. However, in concluding that the defendants violated Rule 10b-5, 17 C.F.R. §240.10b-5 (1981), I would predicate their duty to disclose the Mid-Allegheny Corporation (MAC) dividend solely on the provisions of Rule 10b-17, 17 C.F.R. §240.10b-17 (1981), rather than on the complex of theories set forth in Part III-B of Judge Gibbons' opinion. I thus would not reach the question whether the defendants had a duty to disclose under the New York Stock Exchange (NYSE) listing agreement, the Maryland law of fiduciary obligations, or the New York law of contracts.

I.

Rule 10b-17 provides that the failure of an issuer to give ten days' prior notice of the declaration of a dividend *relating to* a publicly traded security constitutes a "manipulative or deceptive device or contrivance" within the prohibitions of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1976).[1] Here, it is undisputed that while the common stock of the Baltimore & Ohio Railroad Company was not publicly traded or listed on any national securities exchange (99.63 percent of the common stock was owned by the Chesapeake & Ohio Railway Company), the convertible debentures were publicly traded and were listed on the NYSE. Thus, the B & O convertible debentures are a publicly traded class of securities within the meaning of Rule 10b-17.[2] It is also undisputed that the B & O failed to give ten days' notice of its action in declaring the MAC stock dividend to the National Association of Securities Dealers (NASD), or to the NYSE in accordance with the procedures set forth in the B & O's listing agreement with that Exchange.[3] Thus, the only remaining question to be answered is whether the declaration of the MAC

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[1] The Rule states:

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Act for any issuer of a class of securities publicly traded by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange to fail to give notice in accordance with paragraph (b) of this section of the following actions *relating to* such class of securities:
>
> > (1) A dividend or other distribution in cash or in kind, except an ordinary interest payment on a debt security, but including a dividend or distribution of any security of the same or another issuer;
>
> (b) Notice shall be deemed to have been given in accordance with this section only if:
>
> > (1) Given to the National Association of Securities Dealers, Inc., no later than 10 days prior to the record date involved or, in case of a rights subscription or other offering if such 10 days advance notice is not practical, on or before the record date and in no event later than the effective date of the registration statement to which the offering relates . . . [or]
>
> * * *

> (3) Given in accordance with procedures of the national securities exchange or exchanges upon which a security of such issuer is registered pursuant to section 12 of the Act which contain requirements substantially comparable to those set forth in paragraph (b)(1) of this section.

17 C.F.R. §240.10b-17 (1981) (emphasis added).

[2] Rule 10b-17 is not limited to equity securities. That dividends or other distributions relating to debt securities are covered by the Rule is evident from the Rule's exclusion from its notice requirement of "ordinary interest payment[s] on a debt security." Rule 10b-17(a)(1). This clearly indicates that dividends or other distributions relating to debt securities, other than ordinary interest payments, are governed by the Rule. If Rule 10b-17 covers equity and debt securities, it must cover a mixed debt-equity security such as a convertible debenture.

[3] The NYSE listing agreement for the debentures, App. at 457a, entered into by the B & O on March 22, 1956, incorporates by reference an earlier listing agreement between the B & O and the NYSE, dated February 18, 1947. That earlier agreement provided:

dividend was an action "relating to" the publicly traded convertible debentures within the meaning of Rule 10b-17. If Rule 10b-17 applies, a duty of disclosure arises, the breach of which provides the predicate for a violation of Rule 10b-5. *See generally Chiarella v. United States*, 445 U.S. 222, 235 (1980).[4]

II.

The defendants argue that the notice requirements of Rule 10b-17 apply only to dividends declared on publicly listed stock. Because the B & O's common stock was not publicly listed, the defendants argue, no notice was therefore mandated.

> The Corporation [B & O] will give the Exchange at least ten days' notice in advance of the closing of the transfer books, or of the taking of a record of its stockholders for any purpose.
>
> The Corporation will publish promptly to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and shall give prompt notice to the Exchange of any such action; and shall afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights . . .

Id. at 455a. By its terms, the NYSE listing agreement unquestionably includes any action taken, including the declaration of dividends, which affects convertible debentures.

[4] Thus, we need not decide whether a violation of Rule 10b-17, like a violation of Rule 10b-5, 17 C.F.R. §240.10b-5 (1981), itself gives rise to an implied right of action for damages under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1976).

In my opinion, this argument contemplates too restrictive a reading of Rule 10b-17. The Rule was meant to protect the ability of investors to exercise their investment rights to the fullest. It does so by operating to ensure that opportunities to exploit benefits associated with security ownership will not be lost by the withholding of material information. As the SEC explained when it proposed Rule 10b-17, in the absence of disclosure of imminent dividend declarations, "purchasers and their brokers may have entered into and settled securities transactions without knowledge of the accrual of such rights and were thus unable to take necessary steps to protect their interests." Securities Exchange Act Rel. No. 9076, 36 Fed. Reg. 3430 (Feb. 17, 1971).

While it is true that the Rule makes no specific reference to convertible debentures as such, it without question includes such instruments within its classification of "securities publicly traded" and proscribes the failure to give notice of dividends "relating to such class of securities." *See* note 2 *supra*. I agree with the SEC that

> [f]or purposes of determining what information is material to security holders, there is a significant difference between the holders of simple debt securities and the holders of debt securities convertible into stock. The latter own contracts to purchase the stock on specified terms and at a specified price and, as a result, have as great an interest in material facts concerning that stock as do the stockholders.

SEC Amicus Brief at 19 n.17.

It is obvious that a stock dividend declared on common stock comes within the terms of Rule 10b-17. It would be anomalous if a stock dividend which becomes payable simply by the exercise of converting a debenture were not considered as "relating to such class of [convertible debenture] securities." It seems to me that in the context of Rule 10b-17, a dividend "relates to" a security if the declaration of that dividend makes the security significantly more or less valuable, whether by directly increasing or decreasing the value of the security or by enabling the holder of the security to take steps which would either augment the security's worth or prevent the diminution of its value.

Here, the convertible debentureholders claim that the value of the non-rail assets of the B & O which are represented by the MAC dividend roughly approximates $250 million. Prior to the declaration of the MAC dividend, the debentures included the right to convert to B & O common stock which represented both rail and non-rail assets; after the dividend declaration, the debentures were convertible into B & O common stock which no longer represented the non-rail assets and *only* represented the rail assets. Tested by the definition set out above, it is evident to me that the declaration of such a dividend in which the convertible debentureholders could share in both categories of assets by exercising their conversion option, is an action which clearly "relates to" this class of securities.

Accordingly, I agree with Judge Gibbons, who has reached a similar conclusion in his opinion where he has indicated that the MAC dividend "related to the convertible debentures since it was material to a decision about exercising the [debentures'] conversion option." Op. of Gibbons, J., typescript at 14-15. Under the analysis I have suggested, the defendants had a duty under Rule 10b-17 to give advance notice to the NASD or the NYSE (and through them to the convertible debentureholders) of the declaration of the MAC dividend. The conceded failure of the defendants to give such notice rendered them liable in damages under Rule 10b-5. That being the case, there is no need to consider whether any other theory is viable which would impose a duty upon the defendants to give notice to the holders of the convertible debentures.

Accordingly, I join Judge Gibbons' opinion except for Part III-B, and concur in the reversal of the judgment below.

ADAMS, *Circuit Judge*, dissenting.

The Supreme Court recently has made clear that liability for nondisclosure of material information under the federal securities laws cannot be imposed absent a duty to speak. *Chiarella v. United States*, 445 U.S. 222, 235 (1980). Aware of this precept, Judge Gibbons has pointed to no fewer than four possible sources from which to derive a duty, on the part of The Baltimore and Ohio Railroad, to notify its convertible debenture holders prior to the declaration of the MAC dividend. Judge Garth, concurring, has limited the duty analysis solely to the provisions of Rule 10b-17; the holding of the Court, therefore, rests on that narrow ground. Unlike my two colleagues, I conclude that B&O was under no legal obligation—pursuant to Rule 10b-17 or otherwise—to provide plaintiffs with advance notice of the MAC dividend. I therefore respectfully dissent.

I.

Convertible debentures frequently are characterized as "hybrids," embodying the attributes of both debt and equity securities. *See, e.g., Broad v. Rockwell International Corp.*, 642 F.2d 929, 940 (5th Cir.) (en banc), *cert. denied*, 102 S. Ct. 506 (1981); American Bar Foundation, *Commentaries on Indentures* 523 (1971); Note, Hoff and Harff: *Does the Convertible Debenture Holder Have Standing to Maintain a Shareholder Derivative Action?*, 26 Syracuse L. Rev. 730, 751 (1975). As such, they have proven to be an attractive and effective means of corporate financing. Like most debt securities, convertible debentures provide a fixed rate of return and assure the investor priority, over common shareholders, in claims on the issuer's assets. Should the market price of the common stock rise, however, the debentureholder may exercise an option to convert the debt security into shares of common stock. "Thus there is the opportunity to benefit from a rise in stock prices from the comparative safety of a debt . . . position." Katzin, *Financial and Legal Problems in the Use of Convertible Securities*, 24 Bus. Law. 359, 361 (1969).

From the corporation's standpoint, the issuance of convertible debentures can be similarly advantageous. Primarily, the convertible securities provide a way to raise new capital indirectly—by permitting management " 'to raise funds today at tomorrow's higher common stock prices.' " Fleischer & Cary, *The Taxation of Convertible Bonds and Stock*, 74 Harv. L. Rev. 473, 474 (1961) (quoting Pilcher, *Raising Capital with Convertible Securities* 61, 138 (1955)). In addition,

> the new funds will be contributing to income by the time the debentures are converted. In the interim, while the company is putting the new money effectively to work, the charge takes the form of interest —deductible for tax purposes—rather than a reduction in income per share. Thus the dilution of earnings which traditionally accompanies an equity issue is deferred until the firm is making more money.

Id. (footnote omitted). Finally, because the conversion feature is so attractive to investors, the issuer can often offer the debentures at an interest rate lower than that required on other debt securities. Katzin, *supra*, at 362. *But see* Klein, *The Convertible Bond: A Peculiar Package*, 123 U. Pa. L. Rev. 547, 558-59 (1975) (referring to this rationale as "flimflam").

Whatever financial advantages attach to the issuance or purchase of convertible debentures, the legal status of these hybrid securities remains inherently complex. As debt securities, the debentures impose a specific set of obligations on the corporation—namely, the regular payment of interest and the repayment of principal upon maturity. As equity securities, in contrast, the debentures may require a broader range of duties from the issuer. The difficulty lies not in the characterization of the debenture as *either* debt or equity — for it is both — but in determining, in each case, the extent to which the investor is owed rights and remedies beyond those commonly accorded debt holders.[1]

The traditional view is that the convertible debenture holder is a mere creditor until conversion, whose relationship with the issuing corporation is governed by contract and statute. In an early Massachusetts decision, for example, the court rejected a convertible note holder's claim that he had an equitable interest in newly-issued shares of stock. *Pratt v. American Bell Telephone Co.*, 141 Mass. 225, 5 N.E. 307 (1886). The plaintiff was "in no sense a stockholder," declared the court; his "rights and interest as a stockholder of the corporation were postponed to the time when he made his option and demanded his stock. Pending this time, the contract gave him the right to payment of the coupons attached to the notes, and nothing more." 5 N.E. at 311.

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[1] *See Green v. Hamilton Int'l. Corp.*, No. 76 Civ. 5433 (S.D.N.Y. July 14, 1981) ("If the wrongs alleged in this case impacted upon the securities so as to undermine the debtor-creditor relationship, a contract analysis is appropriate, and plaintiffs . . . were owed no special duty outside the bounds of the contract. If the wrongs alleged impinged upon the equity aspects, then the analysis would more properly treat plaintiffs like shareholders to whom the majority shareholders and directors of a corporation owe a duty of 'honesty, loyalty, good faith and fairness.' ").

Several years later, Justice Holmes expanded upon this principle, holding for the Supreme Court of Massachusetts that the debenture holder had no right, apart from contract, to object to corporate actions that dilute or destroy the value of the conversion option:

> [the option] imposes no restriction upon the obligor in regard to the issue of new stock, although the issue may be upon such terms as to diminish the value of the right. It leaves the management of the company in accordance with its other interests unhampered. It is simply an option to take stock as it may turn out to be when the time for choice arrives. The bondholder does not become a stockholder, by his contract, in equity any more than at law . . .
>
> . . . [T]he contract does not prevent the corporation from consolidating with another in such a way as to make performance impossible, any more than it prevents the issue of new stock in such a way as to make performance valueless.

Parkinson v. West End St. Ry. Co., 173 Mass. 446, 53 N.E. 891, 892 (1899). *See also Gay v. Burgess Mills*, 30 R.I. 231, 74 A. 714 (1909). And in *Lisman v. Milwaukee, L.S. & W. Ry. Co.*, 161 F. 472 (E.D. Wis. 1908), *aff'd* 170 F. 1020 (7th

Cir. 1909), the court held that convertible debenture holders could not complain when the railroad company in which they had invested merged with another railroad. The fact that the parties "were bound to" have anticipated such a consolidation when they entered into the option contract was dispositive.

The rights and remedies of convertible debenture holders have expanded since the turn of the century. Most notably, the Securities Exchange Act of 1934 accords convertible debenture holders the federal statutory rights of "equity security holders,"[2] able, for example, to employ section 10(b) of the Act to protect against fraud or manipulative devices. 15 U.S.C. §78j. Congress's explicit recognition of convertibles as equity, as well as debt, securities has had significant consequences. In *Kusner v. First Pennsylvania Corp.*, 531 F.2d 1234 (3d Cir. 1976), for instance, this Court held that a convertible debenture holder, who alleged that he had purchased the securities in reliance on a false and misleading prospectus, had standing to sue under section 19(b). *Kusner* depicts the precise sort of situation in which a section 10(b) remedy is appropriate for debenture holders in their role as equity investors. As the Court explained, in such a case, the debenture holder's need for accurate information about the corporation was as pressing as any shareholder's:

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[2] The Act defines the term "equity security" broadly to include "any stock or similar security: or any security convertible, with or without consideration, into such a security . . ." 15 U.S.C. §78c(11). *See Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107. 110 (2d Cir. 1967): *In re Will of Migel*, 71 Misc. 2d 64). 336 N.Y.S.2d 376, 379 (1972).

> If during the conversion period the value of the common stock (a function of its market price and dividend position) greatly exceeds the value of the fixed payment and interest obligation, a holder probably will exercise the conversion privilege. The possibility that the value of common stock will increase to a point where it exceeds the value of the bond is the sales feature with which the issuer obtained a lower-than-market interest rate on the bond. Thus . . . a misrepresentation in the prospectus that would be material to a stock purchaser would be material to a convertible bond purchaser. The convertible bond purchaser may well have been defrauded of the interest differential.

531 F.2d at 1238 (footnote omitted).

The mere availability of a securities act remedy for fraud, however, does not answer the question whether the common law rule of *Parkinson* remains the applicable standard by which to judge whether or not a corporation has, indeed, acted fraudulently. That question was addressed and analyzed perceptively in a recent en banc Fifth Circuit decision, *Broad v. Rockwell International Corp.*, 642 F.2d 929 (5th Cir.), *cert. denied*, 102 S. Ct. 506 (1981). There, the plaintiff debenture holders complained that when the company in which they had invested was acquired by another entity in a cash merger, they lost their right to convert into common stock. The Court concluded that the plaintiffs had "received . . . all to which they were contractually entitled under the Indenture" and that, as a result, no violation of section 10(b) could have occurred:

> There is no doubt but that there was concerted, intentional conduct by the defendants to bring about [the] result [about which plaintiffs complain]. But as a matter of law, there was no violation of section

> 10(b) or Rule 10b-5 because there was no fraud. "Section 10(b) is aptly described as a catch-all provision, but what it catches must be fraud. *Chiarella v. United States*, 445 U.S. 222, 234-35, . . . (1980) (criminal prosecution under section 10(b) and Rule 10b-5). It is elementary that section 10(b) and Rule 10b-5 reach only conduct involving manipulation or deception. *E.G., Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, . . . (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, . . . (1976). The defendants' conduct involved neither; they merely carried out their contractual obligations. As a conceptual matter, they could not have fraudulently schemed to deprive the holders of Debentures of a right that those holders did not in fact have.

642 F.2d at 963.

Virtually every modern commentator appears to agree with the *Broad* court that convertible debenture holders have no cause to complain about legal corporate conduct that adversely affects the value of the conversion option unless such conduct has been explicitly proscribed or otherwise addressed in the debenture indenture.[3] As explained by the American Bar Foundation:

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[3] The "indenture" is the document that sets forth the terms under which the debenture has been issued, including the redemption rights of the issuer, the conversion rights of the investor, and any number of administrative or procedural provisions. The indenture is usually conceived of as a contract between the issuer and a trustee for the benefit of the debenture holders. *See generally* Commentaries, *supra* at 7-8. Since 1939, debenture holders have been protected by federal law against breaches of fiduciary duty by the trustee. Trust Indenture Act of 1939. 15 U.S.C. §§77 aaa *et seq.* (1976). *See Zeffiro v. First Penn. Banking and Trust Co.*, 473 F. Supp. 201 (E.D. Pa. 1979). aff'd, 623 F.2d 290 (3d Cir. 1980).

> Inasmuch as ownership of a convertible debenture does not give the holder the rights of a shareholder, the holder of a convertible debenture would have almost no protection against acts by the Company which would adversely affect the value of the common stock issuable on conversion, such as split-up of shares, stock dividends, distribution of assets, issuance or sale of other convertible securities, issuance of options, issuance or sale of common stock at prices below the current conversion or market price, merger, sale of assets or dissolution and liquidation of the Company. Events of this type are customarily described as "diluting" the value of the conversion privilege, *and if protection is desired against such dilution, appropriate provisions must be included in the indenture.*

Commentaries, *supra*" at 527 (emphasis added) footnote omitted). *See also Broad v. Rockwell International Corp., supra* at 943; *Kessler v. General Cable Corp.*, 92 Cal. App. 3d 531, 155 Cal. Rep. 94, 99-100 (1979); 6A W. *Fletcher Cyclopedia of the Law of Private Corporations* §§2694-2694.1 (perm. ed. 1981). Such so-called "anti-dilution clauses" are thus among the most important of the various contract provisions that can be negotiated between the issuing corporation and the debenture holders or their representatives.[4] Commonly, they require the corporation to give the debenture holder advance notice of specific acts that may erode or destroy the conversion option, so that the investor can convert, if he so chooses, prior to the act in question. Alternatively, the anti-dilution clause can provide for the adjustment of the conversion price to reflect the change in value. *See* Irvine, *Some Comments Regarding "Anti-Dilution" Provisions Applicable to Convertible Securities*, 13 Bus. Law. 729 (1958). Less frequently, the anti-dilution provision is drafted to prohibit the corporation from taking certain actions that may cause diminution in the value of the conversion option. *See* Commentaries, *supra*, at 527-28.

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[4] *See* Hills, *Convertible Securities—Legal Aspects and Draftsmanship*, 19 Calif. L. Rev. 1, 1-2 (1930) ("Poor draftsmanship and a disregard of possible corporate changes, rather than a general misunderstanding of the conversion privilege, may be set down as the principal causes of litigation on this subject. The decisions result-

The conduct at issue in the present case — namely, the transfer of B&O's non-rail assets to MAC and the distribution of the MAC stock to B&O's common shareholders — is clearly of the sort that could have been addressed by the inclusion of an appropriate anti-dilution provision within the indenture. Such a provision could have taken any number of forms. In its Commentaries on the Model Debenture Indenture provisions, for instance, the American Bar Foundation noted that "[w]hen dividends are declared and paid other than in

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ing from such litigation have acted as danger signals, attorneys have become more careful and litigation has been reduced to a minimum."); Kaplan, *Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities*, 33 U. Chi,. L. Rev. 1, 29 (1965) ("The anti-dilution clause in an integral and necessary part of any convertible security. The clause is a complex, difficult and intriguing exercise in corporate draftsmanship. It requires the draftsman to protect against the whole gamut of potential corporate rearrangement or manipulation which might adversely affect the rights of the holders of the convertible securities. So intricate and precise an instrument should be prepared with the greatest care and diligence.").

shares of common stock or as normal cash dividends," the debenture holder's conversion rights can be protected against dilution "by providing for a reduction of the conversion price to reflect the diminution of the corporate assets resulting from such dividends." Commentaries, *supra*, at 529. Moreover, the Bar Foundation continued, "[i]t is sometimes provided that, upon exercise of his conversion rights, the debentureholder shall receive, in addition to the shares to which he is entitled, the amount of assets (or a sum equal to the value thereof) which would have been distributed to him if he had exercised his right to convert immediately prior to the record date for such distribution." *Id.*[5] And at least one commentator has suggested that it is advisable to insert in the indenture a provision giving holders of convertible securities adequate notice in the event that "the Company shall propose . . . to pay any dividend payable in stock of any class to the holders of its Common Stock *or to make any other distribution to the holders of its Common Stock (other than a cash dividend payable out of earnings or earned surplus legally available for the payment of dividends* . . .)." Kaplan, *supra* note 4, at 13 n.24 (emphasis added). Such a notice provision would clearly encompass the kind of arrangement against which Pittsburgh Terminal has complained in the case at bar.

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[5] The model indenture discussed in the *Commentaries* includes at least two provisions that address this point. One stipulates, for example, that:

> In the event that the Company shall make *any distribution of its assets* upon or with respect to its Common Stock, as a liquidating or partial liquidating dividend, *or other than as a dividend payable out of earnings or any surplus legally available for dividends* under the laws of the state of incorporation of the Company, each Holder of any Debenture then Outstanding shall, upon the exercise of his right to convert after the record date for such distribution, or in the absence of a record date, after the date of such distribution, receive, in addition to the shares subscribed for, the amount of such assets (or, at the option of the Company, a sum equal to the value thereof at the time of distribution as determined by the Board of Directors in its sole discretion) which would have been distributed to such Holder if he had exercised his right to convert immediately prior to the record date for such distribution, or, in the absence of a record date, immediately prior to the date of such distribution.

Significantly, although the commentators have been careful to consider the situation in which a corporation distributes its assets in forms other than ordinary cash or stock dividends, the indenture at issue here contains no such provision. While the indenture does address a variety of potentially diluting acts — including a change in the par value of the outstanding common stock; a change of outstanding common stock from par to no par; and a possible consolidation, merger, or sale of the company — we have been directed to no provision in the indenture here that addresses the situation in which the company spins off a portion of its assets to a subsidiary

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Commentaries, supra, at 547 (emphasis added) (footnote omitted). An alternate provision, addressing the situation in which the corporation distributes to its shareholders "evidences of its indebtedness or assets" excluding dividends paid out of earned surplus, declares that "in each such case the Conversion Price shall be adjusted" to compensate for the distribution of the corporation's assets to its shareholders. *Id.* at 553.

and distributes those assets, in the form of a stock dividend, to its common shareholders. Plaintiffs are able to point to only one section in the indenture that is even arguably apposite. That provision, entitled "Notice to be Given of Record Date for Stock Dividend, etc.," provides that:

> The Company covenants and agrees that it will not declare and/or pay any dividend on its common stock *payable in stock* or create any rights to subscribe for stock or securities convertible into stock unless in any such case notice of the taking of a record date for the determination of the stockholders entitled to receive such dividend, distribution or right is given at least ten days prior thereto by at least one publication in an Authorized Newspaper.

Indenture Article 5, Section 12 (appendix at 357a) (emphasis added).

Plaintiffs assert that the term "stock dividend" in the table of contents, as well as the words "payable in stock," which are found in the body of the provision, suggest that the clause is "in no way limited to the common stock of the B & O," but, rather, applies to distributions of MAC stock as well. Brief of Appellant at 34. Plaintiffs also contend that, even assuming the phrase "payable in stock" refers only to B & O common stock, the provision violates the New York[6] requirement of fair dealing. I find neither of these two arguments convincing.

It is a well-established principle of New York corporate law that a "stock dividend" is "any dividend payable in stock *of the corporation declaring or authorizing such dividend.*" *In re Fosdick's Trust,* 4 Misc. 2d 1003, 147 N.Y.S.2d 509, 514 (1955) (emphasis added), *aff'd* 3 App. Div. 2d 1000, 165 N.Y.S. 2d 429 (1957), *aff'd* 4 N.Y.S. 2d 646, 176 N.Y.S.2d 966, 152 N.E.2d 228 (1958); 11 W. *Fletcher Cyclopedia of the Law of Private Corporations* §5359 (perm. ed. 1971). The declaration of such a dividend generally is conceived of as a capitalization of surplus, which neither depletes the assets of the corporation nor increases the holdings of the stockholder. *See Gibbons v. Mahon,* 136 U.S. 549, 559-60 (1890); *Equitable Trust Co. v. Prentice,* 250 N.Y. 1, 164 N.E. 723, 725 (1928) (Cardozo, C.J.) ("When a dividend is paid in cash, the ownership of the corporate assets is changed; the company owns less, and the shareholder owns more, or something essentially different, though its value be no greater. Upon the distribution of a stock dividend, ownership of the assets is precisely as it was. 'A stock dividend does not distribute property, but simply dilutes the shares as they existed before.' "). Thus stock dividends traditionally have been distinguished "from [dividends] payable in the stock of a subsidiary" or another independent corporation. *Id.; see also Kellogg v. Kellogg,* 166 Misc. 791, 4 N.Y.S.2d 219, 221, *aff'd,* 254 App. Div. 812, 5 N.Y.S.2d 506 (1938). The latter sort of dividend — stock in subsidiaries or other corporations — is considered the equivalent of a cash dividend — "diminish[ing] the property of the corporation by exactly the amount paid out and correspondingly increas[ing] the property of the individual stockholders. . . ." 11 *W. Fletcher Cyclopedia of the Law of Private Corporations* §5355 (perm. ed. 1971) (footnote omitted).

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[6] As Judge Gibbons notes, the B & O indenture was entered into in New York and must be construed under the laws of that state. Typescript op. at 15.

Applying these precepts to the case at hand, it is clear that the distribution of the MAC stock was *not* a "stock dividend," as that term traditionally has been defined. B & O was not capitalizing surplus; it was divesting itself of a considerable portion of its assets. In practical terms, the effect of the MAC dividend was no different than if B & O had sold its non-rail assets for cash and then distributed an extraordinary cash dividend to its shareholders.[7] *See Venner v. Southern Pac. Co.*, 279 F. 832, 840 (2d Cir.), *cert. denied*, 258 U.S. 628 (1922). Had the B & O indenture contained a more broadly inclusive notice clause, B & O might have been required to inform the debenture holders prior to the declaration of the MAC dividend. The sample provision quoted above, for example, requires notice both for dividends "payable in stock of any class" and for "any other distribution," excluding normal cash dividends. Kaplan, *supra* note 4, at 13 n.24. But the fact remains that the B & O indenture contains no such clause. Accordingly, the plaintiffs cannot rely upon the terms of the indenture as a source of B & O's purported duty to speak.

Apparently mindful of the limited protection afforded to them by the indenture, the plaintiffs maintain that, notwithstanding any lack of an adequate notice provision within the indenture, New York's law of fair dealing required that in any event notice be given prior to the declaration of the MAC dividend. Judge Gibbons credits this argument, concluding that, in failing to give notice, B & O violated the principle "that in every con-

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7. Because it is the equivalent of an *extraordinary* cash dividend, the distribution of the MAC stock is not governed by the provisions of Article 5. Section 2 of the Indenture which apply only to "regular dividends" and exclude "extraordinary dividends of every character." Appendix at 348a—49a.

tract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract . . ." Typescript op. at 15-16 (quoting *Kirke La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933)).

Such an analysis is clearly inappropriate. By its terms, the principle of fair dealing expressed in *Kirke* and quoted by Judge Gibbons applies only when one party infringes the other's *rights* "to receive the fruits of the contract." Here, under the well-settled *Parkinson* doctrine, Pittsburgh Terminal *had no right*, under the contract, to receive advance notice of the MAC dividend because *no anti-dilution provision to that effect had been included in the indenture.* Thus, the risk of dilution was "inherent in the investment made by the holders of Debentures . . . [B & O] did nothing that could be described as 'destroying or injuring the right of the other party to receive the fruits of the contract,' because . . . the benefits that the holders of Debentures received were all the rights to which they were contractually entitled." *Broad v. Rockwell International Corp., supra* at 958.

Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir.), *cert. denied*, 423 U.S. 947 (1975), *appeal after remand*, 553 F.2d 812 (2d Cir. 1977), a Second Circuit case relied upon by Judge Gibbons, does not support a contrary result. In *Van Gemert*, debenture holders complained that Boeing had provided inadequate notice of its intention to redeem the debentures, thereby depriving the investors of the opportunity to convert prior to redemption. The Second Circuit agreed. Observing that the newspaper notice that was provided "may have conformed to the requirements of the Indenture," the court nonetheless concluded that such notice "was simply insufficient" under New York's fair dealing law "to give fair and reasonable notice to the debenture holders." 520 F.2d at 1383. In its decision after remand, the court clarified its earlier decision:

> We did find significant . . . the fact that the debentures did not explicitly set forth the type of notice which appellants could expect if Boeing decided to call the bonds. Without such a declaration, we held as a matter of law that appellants were entitled to expect that Boeing would employ a method of notification reasonably calculated to inform the debenture holders of the call.

553 F.2d at 815.

Van Gemert thus stands for the narrow proposition that, if the debenture holders are contractually entitled to notice, such notice must be "fair and reasonable." But *Van Gemert* in no way addresses the question posed to us today: namely, whether the B & O debenture holders were entitled to any notice at all. That question, as has already been suggested, can be answered only by reference to the language of the indenture itself.

II.

The conclusion that B & O was under no contractual obligation to provide advance notice of the MAC dividend to its convertible debenture holders does not, of course, end the inquiry. For while it is clear that, as a general rule, the debenture holders' rights are limited to those specified in the indenture, the Court today has determined that SEC Rule 10b-17 furnishes an independent statutory source from which to derive a duty, on the part of B & O, to provide notice of the MAC dividend. I turn, therefore, to an examination of this issue.

Rule 10b-17 provides that

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Act for any issuer of a class of securities . . . to fail to give notice in accordance with paragraph (b) of this section of the following actions *relating to such class of securities:*
>
> (1) A dividend or other distribution in cash or in kind, except an ordinary interest payment on a debt security, but including a dividend or distribution of any security of the same or another issuer; . . .

17 C.F.R. §240.10b-17(1981) (emphasis added). Judge Gibbons has concluded that Rule 10b-17 applies to the situation at hand because "B & O is the issuer of the convertible debentures, the MAC distribution is a dividend of a security, and that dividend related to the convertible debentures since it was material to a decision about exercising the conversion option." Typescript op. at 14-15. Judge Garth, concurring exclusively on this ground, stresses that, in his view, "a dividend 'relates to' a security if the declaration of that dividend makes the security significantly more or less valuable . . . " Typescript op. at 4-5. Because the B & O debentures were of considerably less value after the declaration of the MAC dividend, Judge Garth has concluded that the declaration of the dividend "is an action which clearly 'relates to' " that class of securities.

I do not disagree that the MAC dividend may have been "material" to the debenture holders' decision whether or not to convert their securities into shares of common stock. Nor do I take issue with Judge Garth's determination that the debentures were less valuable after the declaration of the dividend. Nonetheless, in my view, these considerations are not sufficient to establish that the dividend declaration "related to" the class of debenture securities as that term is used in Rule 10b-17. Put simply, Rule 10b-17 never was meant to deal with a situation similar to that before us today.

Nothing in the Commission's "Notice of Proposed Rule Making" or in the language of the rule itself suggests that Rule 10b-17 was intended to override the common law and accord debenture holders significant additional *substantive* rights. When the Rule was proposed by the Securities Exchange Commission in 1971, it was described as a rule "to require companies whose securities are publicly traded to furnish public investors with timely advance notice of the *right to receive dividend[s] and other rights which accrue to holders of record* of a specified class of securities as of a specialized date ('the record date')." 36 Fed. Reg. 3430 (1971) In other words, the Rule was designed to ensure that purchasers of securities receive all the fruits of the transaction *to which they legally are entitled* — namely, distributions made after the sale but before the change in ownership is reflected in the corporation's record books.[8] Detailing the circumstances that had prompted the proposal, the Commission explained:

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[8] The Rule presumably provides a remedy for sellers as well. *See Lutgert v. Vanderbilt Bank*, 508 F.2d 1035 (5th Cir. 1975). In *Lutgert* — the only case to my knowledge that has discussed the intended scope of Rule 10b-17—the court described "the type of claim for which Rule 10b-17 was intended to provide relief";

When an issuer establishes a record date it is, in general, obligated to furnish the cash, securities, or other property or property rights that are the subject of the distribution only to those persons owning the underlying security as reflected in the issuer's records. However, not all transactions occurring prior to that cut-off date can be settled and appropriate changes effected on the issuer's records to provide assurance that the distributions of the rights will actually be made by the issuer to purchasers. Since during this period purchasers pay a price for the underlying security which indicates the value of the asset to be distributed, it has therefore been the practice and custom of the trade for brokers and dealers to render the purchaser as the person entitled to the distribution which is made by the issuer to the seller as record owner. *If the participating brokers have notice of the cut-off date, they can take necessary steps at settlement . . . to protect the right of the purchaser to the distribution and at the*

For example, if the owner of . . . stock prior to the record date were to sell his stock within the ten-day disclosure period referred to in Rule 10b-17 unaware, due to defendants' non-disclosure, that the record date had been set, it is conceivable that he might make out a claim for relief under Rule 10b-17. Plaintiff in such a case would have been a seller of . . . stock and would have been defrauded in connection with that sale.

508 F.2d at 1038-39.

> *same time alert the seller to his obligation to turn over the distributed property to the purchaser.*

Id. at 3430-31 (emphasis added). The failure of publicly held corporations to provide such notice

> has had a misleading and deceptive effect on both the broker-dealer community and the investing public. As a direct result of such failure, purchasers and their brokers may have entered into and settled securities transactions without knowledge of the accrual of such rights and were thus unable to take necessary steps to protect their interests. Further, sellers who have received the benefits of such rights as recordholders on the specified record date after having disposed of their securities, have also disposed of the cash or stock dividends or other rights received as such recordholders without knowledge of possible claims of purchasers of the underlying security to those rights.

Id. at 3430.

The differences between the scenario depicted by the SEC and the present case could not be more obvious. In the situation described by the SEC, the purchaser — independent of Rule 10b-17 — has accrued the *right* to receive certain benefits. In such a case, the Rule acts simply to assure that these rights will not be impeded because of the inadequacies inherent in corporate bookkeeping. Here, in contrast, the debenture holders have a right to convert their debentures into shares of common stock. That right has not been defeated. Under well-established common law principles, however, they have no right — unless otherwise specified in the debenture — to notice of corporate actions that may affect the value of the conversion option.

Had the debenture holders foreseen the possibility that B & O would spin off its non-rail assets, arguably they may have bargained for— and paid for — the right to advance notice of the event.[9] Despite the well-settled precedent of *Pratt* and *Parkinson*, however, the B & O indenture did not require such notice to the debenture holders and the price of the debenture presumably reflected this fact. For this Court today — almost thirty years after the drafting of the indenture — to ignore what was set forth as the intent of the parties and fundamentally to alter the terms of the contract is, in my view, not only legally erroneous but improvident.[10]

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[9] Concededly, the debenture holders themselves do not, in the average case, bargin individually with the issuing corporation. *See* Note, *Convertible Securities: Holder Who Fails to Convert Before Expiration of the Conversion Period*, 54 Cornell L. Rev. 271, 272 (1969). But attorneys or investment bankers normally perform this function on behalf of the debenture holders as a class, *see e.g.*, Hills, *supra* note 4; Kaplan, *supra* note 4, and there is no suggestion in this case that those persons who bargined on behalf of the B & O debenture holders did so other than with diligence and vigor.

[10] In this regard it is instructive to consider the views expressed by Judge Tyler in *Entel v. Guilden*, 223 F. Supp. 129, 131-32 (S.D.N.Y. 1963):

> One of the chief economic functions of a corporation, obviously, is to facilitate aggregations of capital. To further this function, there has developed a broad range of modes of investment within the corporate framework. Each such mode is a bundle of legal rights and duties; the market price for each bundle is no double determined at least in part by what the bundle contains. Thus, courts should act with conservatism in changing the content of any of these bundles in ways which would give the holders of some bundles less, and holders of other bundles more, than was bargained for in the marketplace.

I therefore respectfully dissent.[11]

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

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[11] Judge Gibbons has posited two additional sources from which he derives a duty to speak — namely, the New York Stock Exchange Listing Agreement and the Maryland law of fiduciary obligations. While the court's holding does not rest on either of these alleged sources. I note that, for essentially the reasons stated in parts I and II of this opinion. I find that neither the listing agreement nor the Maryland law creates the asserted duty to provide notice in this context.

APPENDIX B

IN THE
UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

PITTSBURGH TERMINAL CORP. v. BALTIMORE & OHIO RAILROAD CO.	Civil Action No. 77-1455
MONROE GUTTMAN, ET AL. v. BALTIMORE & OHIO RAILROAD CO.	Civil Action No. 79-94

March 10, 1981.

OPINION

KNOX, District Judge

A. Introduction and History of Case.

In the Pittsburgh Terminal case at Civil Action No. 77-1455 filed December 28, 1977, the plaintiff of whom Monroe Guttmann, lead plaintiff in Civil Action No. 79-94 was president, filed a complaint against the Baltimore and Ohio Railroad Company alleging that it was a Pennsylvania corporation and that the defendant Baltimore and Ohio Railroad Company (B & O) was a Maryland corporation with its principal offices in Baltimore. The other defendant, Chesapeake and Ohio Railway Company (C & O) was a Virginia corporation with its principal place of business in Cleveland, Ohio and so was the defendant Chessie System Inc., (Chessie) a Virginia corporation with its principal offices and place of business in Cleveland. The complaint alleged that plaintiff was the owner of certain B & O convertible 4½% debentures Series A due January 1, 2010 in an amount in excess of $50,000.

It was further alleged that as a result of certain purchases by C & O during the period from 1960 to date, 99.63% of the B & O common stock was now owned or controlled by C & O and that no dividends had been paid on B & O common stock since 1961.

It was further alleged that on December 14, 1977, without any notice to plaintiff or other persons similarly situated, the B & O suddenly announced that it had declared a dividend on its common stock on a share per share basis on the stock of Mid-Allegheny Corporation, a wholly-owned subsidiary, payable to shareholders of record on December 13, 1977. The action had been taken on December 13, 1977, without prior notice to anyone including particularly the convertible debentureholders of whom plaintiff was one. He claimed that this was a violation of SEC Rule 10(b) and Section 10(b) of the Securities and Exchange Act and that there had been a conspiracy to defraud, deceive and mislead plaintiff with regard to its right to convert its debentures. By having B & O declare and pay a dividend the value of which was undisclosed on December 13, 1977, plaintiff was thereby deprived of the opportunity to make an intelligent decision whether to convert its debentures into common stock and thus receive the dividend. It was claimed that this was also in violation of Article 5, Section 12 of the Trust Indenture of which more hereafter and asked that the defendants be enjoined from having the dividend of Mid-Allegheny Corporation (hereinafter MAC) paid to B & O shareholders without first affording plaintiff adequate information and opportunity to determine whether to convert its debentures into common stock and receive the dividend. The complaint asked that a preliminary injunction be issued thereafter to become permanent, to restrain defendants from paying any dividends in the future without first affording adequate information and opportunity to decide whether to convert.

A hearing was held on the application for preliminary injunction and on March 7, 1978, the court issued a preliminary injunction restraining defendants from proceeding with the dividend. On March 14, 1978, the defendants appealed to the Court of Appeals for this Circuit. On August 9, 1978, the granted preliminary injunction was reversed by the Third Circuit.

Since the defendants agreed to hold sufficient shares of B & O and MAC stock in their possession to satisfy plaintiffs' claim in the event that it was ultimately determined that plaintiff was entitled to reasonable notice of the dividend and plaintiffs elected to convert, the appeals court held that no injunction was necessary. The granting of a preliminary injunction was reversed with directions to the district court to take "such other steps, if any, as may be required to implement the assurances of defendant's counsel that sufficient shares of B & O and MAC will be available to satisfy any final judgment in plaintiffs' favor, all in accordance with the opinion of this court". A copy of the certified order was issued in lieu of formal mandate on August 9, 1978 and after various arguments, the court, on March 27, 1979, entered an order allowing the defendants to hold sufficient shares pending the ultimate decision of the plaintiff's case and whether it elected to convert.

On February 15, 1979, an amended complaint was filed by Pittsburgh Terminal adding various other allegations to the complaint and in the prayer for relief there was included a prayer for damages (paragraph 4 of the amended complaint) which the circuit had noticed was lacking in the complaint as before it.

The case then proceeded through many tortuous discovery procedures. Plaintiff's motion for partial summary judgment and motion of defendants for summary judgment were briefed and argued and denied by orders of June 24, and June 25, 1980, respectively except the motion was granted to the extent of dismissing the action as to Stephen Muller, Nicholas T. Camicia, and a short time later Cyrus S. Eaton named as directors or former directors of the B & O and the other defendants. These directors were released because they were not directors at the time the action was taken or as in the case of Mr. Eaton it was not denied that he had no knowledge and no participation in the declaration of the dividend in question.

In the Guttmann case filed January 22, 1979, a suit was brought by Monroe Guttmann in his own right, Loretta Guttmann, Janet Rees and Evelyn Bittner. The compalint alleged that Monroe, Loretta and Janet Rees were residents of Pennsylvania and the holders of $723,000 in face value of the 4½% convertible debentures due January 1, 2010, all of which were acquired prior to December 13, 1977, the date of the dividend and that plaintiff Evelyn Bittner was a resident of Pennsylvania holding debentures in the face amount of $10,000 acquired prior to December 13, 1977. The defendants were the same being the B & O, its directors, the C & O and the Chessie System, Inc. The two cases have proceeded together and were tried together.

It should be noted that there is waiting in the wings a third case, namely Lucille Lowry and Lowry Zweig Corp. v. Baltimore and Ohio Railroad Company, Civil Action No. 79-1504, filed October 22, 1979, over ten months after the dividend in question had been declared. The court has allowed the Lowry case to proceed as a class action but has refused to consolidate it with the Guttmann and Pittsburgh Terminal cases for the reason that on June 16, 1980, the latter were ready for trial and there were distinct factual issues in the Lowry cases which should be heard separately. The court has refused to allow a class action in the Pittsburgh Terminal or Guttmann cases for the reason it appears that the facts were not typical of facts related to other debentureholders and it appeared that the representation would be inadequate. The motion for class certification was further denied because the motion was made after the cases had been pending for approximately two years in complete violation of Rule 34(c) of this district court requiring that motions to certify class actions be presented to the court within 90 days of filing a complaint in a class action.

In the Guttmann case as in the Pittsburgh Terminal case, motions for summary judgment were filed by the parties and both were denied. The case went to trial non-jury for 4 days, July 21-24, 1980. Thereafter, briefs and arguments were held together with a reargument on one matter which the court felt was inadequately presented and the case is now ready for decision.

B. FINDINGS OF FACT.

(1) The Baltimore and Ohio Railroad Company is incorporated under the law of Maryland with the principal office in Baltimore, Maryland.

(2) On December 13, 1977, 99.63% of the common stock of the B & O was owned by the C & O.

(3) The C & O is a wholly-owned subsidiary of Chessie.

(4) The Mid-Allegheny Corporation ("MAC") on December 13, 1977, was a wholly-owned subsidiary of the B & O.

(5) Chessie Resources is a wholly-owned subsidiary of Chessie formed for the purpose of developing non-coal mineral real estate and timber lands of Chessie and its subsidiaries.

(6) Plaintiffs were on December 13, 1977 and are holders of certain B & O Convertible 4½% debentures, Series A, maturing January 1, 2010.

(7) The plaintiffs are as follows:

A. Pittsburgh Terminal Corporation is a Pennsylvania Corporation and holds $94,000 in face value of the B & O Convertible 4½% debentures Series A, due January 1, 2010 at issue in this case. The $94,000 in debentures were acquired prior to December 13, 1977.

B. Monroe Guttmann held on December 13, 1977, debentures in the face amount of $446,000 acquired prior to December 13, 1977. Debentures in the face amount of $9,000 acquired prior to December 13, 1977 were subsequently converted into B & O common stock.

C. Loretta Guttmann held on December 13, 1977, debentures in the face amount of $226,000 acquired prior to December 13, 1977. Debentures in the face amount of $2,000 acquired prior to December 13, 1977, were subsequently converted into B & O common stock.

D. Evelyn Bittner held on December 13, 1977, debentures in the face amount of $10,000 acquired prior to December 13, 1977.

E. Janet Rees on December 13, 1977, held debentures in the face amount of $50,000 acquired prior to December 13, 1977.

(8) Chessie was one of the last of the major railroads in America to segregate its non-rail assets from its rail assets.

(9) The Chessie Corporate Restructuring Committee (the "Committee") was officially formed in January, 1977.

(10) The Committee was composed of a number of officers and employees of the B & O, Chessie and its subsididaries with various areas of expertise including the law.

(11) One of the purposes for the formulation of the Committee was to consider the transfer of the non-rail assets of the B & O into a corporation not subject to the jurisdiction of the Interstate Commerce Commission so that, inter alia, they would not be subject to the ICC's ban on transportations by a rail carrier of goods manufactured by the carrier or its subsidiaries and the ICC requirement that it must approve all securities issued by a carrier. This requirement renders impossible any joint venture for the purpose of development of real estate by the B & O such as the development of its Georgetown property.

(12) The properties selected for transfer by the Committee were those with potential for development.

(13) In deciding the method of transferring the non-rail properties to a non-rail subsidiary, consideration was given to selling the properties.

(14) The sale method of transfer was rejected because it would have required expensive and time-

consuming appraisals (as much as two years for the coal properties alone) and would have required the transfer of substantial amounts of cash and the payment by the B & O of substantial transfer taxes with the risk that the price for the sale would be unfair to the minority shareowners.

(15) The method of transfer of the non-rail properties chosen by the Committee was transferral into a wholly-owned subsidiary of the B & O followed by the declaration of a dividend in its shares to the common shareowners of the B & O.

(16) Whenever any properties were transferred that had rail facilities of any nature, the B & O was granted a permanent easement for the use of those rail facilities.

(17) On December 13, 1977, the B & O declared a dividend in the shares of MAC. This dividend was part of the corporate restructuring program of the entire Chessie System which had begun in 1973 with the formation of Chessie.

(18) The effect of the transfer of the non-rail properties by the dividend route was that the B & O shareholders each retained their same proportionate interests in both the rail properties retained by the B & O and the non-rail properties transferred to MAC.

(19) Prior to the B & O dividend of the MAC stock in December, 1977, the B & O had not paid any dividend since 1961.

(20) The B & O had not paid any dividends during the period from 1961 to 1977 in part because of its weak financial condition and the need to replace a substantial amount of its operating equipment, in part because of substantial bond maturities and in part because of a re-

quirement in the convertible income bond indenture that the B & O pay an amount equal to any dividend into the surplus income sinking fund.

(21) During that same period and even before the C & O had acquired a controlling interest in the B & O, the C & O had provided the B & O with a significant infusion of capital, without which the B & O could not have remained in operation.

(22) Because it was difficult, if not impossible, to value the MAC dividend in terms of fair market value, the decision was made to call the convertible income bonds, since without calling the bonds, it would not have been possible to pay the MAC dividend.

(23) The convertible income bonds were called at a price of $105 per $100 face value during the summer of 1977 at a time when the bonds were being thinly traded at a price of $60 per $100 face value.

(24) At the time of the call of the convertible income bonds, not all of the properties had been selected for transfer by way of the MAC dividend.

(25) The convertible 4½% debentures, Series A, due January 1, 2010, held by plaintiffs and involved in this suit were issued in 1956 on an offer of exchange for outstanding B & O convertible 4½% bonds.

(26) On or about January 1, 1956 the B & O had entered into an indenture with the Chase Manhattan Bank pursuant to which Chase acted as trustee for the debenture issue.

A. Defendants did not file with the Chase Manhattan Bank as Trustees of the Indenture dated 1/1/1956 for the issue of debentures a copy of any published notice concerning the declaration of the MAC dividend on December 13, 1977.

B. Defendants did not advertise notice of the proposed declaration of the dividend in MAC shares on the B & O common stock in a newspaper of general circulation in the Borough of Manhattan, City and State of New York printed in the English language.

(27) Under the terms of the indenture each $1,000 principal amount of debentures could be converted to 10 shares of common stock of B & O. In this respect the indenture provides inter alia:

> At the election of the holder thereof, any outstanding debentures of Series A may (subject to the provisions of this Article Five) be converted at their principal amount into shares (fully paid and nonassessable and of the par value of one hundred dollars each) of common stock of the company, at any time up to fifteen days prior to the date of the stated maturity of such debentures, or if such debentures shall be called for redemption, up to fifteen days prior to the date fixed for such redemption at the conversion price of $100 per share.

(28) In March, 1956, the B & O entered into a "listing agreement" with the New York Stock Exchange relating to the listing of these *debentures* with the Exchange. The B & O's listing agreement provided:

> The listing agreements set forth in the company's listing application A 12653 and A-15928 are incorporated herein by reference and made a part hereof . . .

(29) On or about April, 1977, Robert F. Hochwarth and John A. Rogers, head of the Committee, both of whom are attorneys, reviewed the terms of the convertible debenture indenture, with specific reference to Arti-

cle 5, Section 12, and concluded that the indenture did not require notice to the debentureholders of the declaration of the MAC dividend. Section 12 provides as follows:

> "The company convenants and agrees that it will not declare and/or pay any dividend on its common stock payable in stock or create any rights to subscribe for stock or securities convertible into stock unless in any such case notice of the taking of a record date for the determination of the stockholders entitled to receive such dividend, distribution or right is given at least ten days prior thereto by at least one publication in an Authorized Newspaper. A copy of each such published notice shall promptly after such publication be filed with the Trustee."

The terms "Authorized Newpaper" are defined in Article 1,

Section 1, ¶2 of the Indenture (P Ex 11) to mean:

> " 'Authorized Newpaper' means a newspaper of general circulation in the Borough of Manhattan, City and State of New York, printed in the English language and customarily published on each business day, whether or not published on Saturdays, Sundays and holidays."

(30) In arriving at this conclusion, Mr. Hochwarth determined that the word "stock" in section 12 referred only to the stock of the B & O and that the payment of a dividend in kind of the stock of another corporation was similar to a cash dividend. With this, the court agrees.

(31) In addition to Messrs. Hochwarth and Rogers, Doyle Morris and Roland Donnem, also attorneys for the B & O, were likewise consulted about these matters and reached the same conclusions.

(32) Mr. Hochwarth in reaching his conclusion with respect to the absence of need for notice to the debentureholders took into account the fact that under the applicable Maryland law, absent any action by the Board of Directors, the payment date of a dividend was the same as the declaration date.

(33) Mr. Hochwarth also considered the requirements of the New York Stock Exchange with regard to the notice of certain dividends and concluded it was inapplicable because it requires 10 days notice only with regard to a dividend declared on listed stocks and the B & O common stock was not listed.

(34) Listing Agreement A-12653, referred to in the B & O's March, 1956 Listing Agreement, provided under "AGREEMENTS" inter alia:

Section 1, Paragraph 2:

> The Corporation will promptly notify the Exchange in the event that it or any company controlled by it shall dispose of any property or of any stock interest in any of its subsidiary or controlled companies, when the disposal thereof will materially affect the financial position of the Corporation or the nature or extent of its operations.

Section III, Paragraph 4:

> The Corporation will give the Exchange at least *ten days' notice* in advance of the closing of the transfer books, or of the taking of a record of its stockholders *for any purpose.*

(35) The A—12653 Listing Agreement under "ARGEEMENTS" also provided:

Section III, Paragraph 5:

> The Corporation will publish promptly to the holders of *any* of its securities listed on the Exchange *any action taken* by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and shall give *prompt* notice to the Exchange of any such action; *and shall afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights*. . . .

(36) The B & O, like all other corporations that have securities listed with the New York Stock Exchange, are bound by the rules of the Exchange as well as their "listing agreements".

(37) Section A-2 of the Exchange Manual entitled "Timely Disclosure", states:

> A corporation whose securities are listed on the New York Stock Exchange, Inc., is expected to release to the public any news or information which might reasonably be expected to materially affect the market for those securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the Exchange.

(38) Defendants did not provide plaintiffs or the other debentureholders notice of the December 13, 1977, dividend-in-kind of Mid-Allegheny Stock.

(39) The Committee was advised by counsel that making the MAC dividend payable on the same date as the date of declaration did not violate the terms of the indenture under which the convertible debentures were issued.

(40) Mr. Donnem, as Senior Vice President, Law, and General Counsel, has the responsibility to render legal opinions concerning railroad activities to the senior officers and directors of the B & O.

(41) Among those individuals to whom Mr. Donnem conveyed his legal opinion concerning the legality of making the declaration and payment of the MAC dividend on the same date were Robert L. Hintz, Senior Vice President of Finance for Chessie, B & O, and C & O and Hays T. Watkins, Jr., Chairman and President of Chessie System, Inc., Chairman of the Board of the C & O and Vice Chairman of the Board of the B & O.

(42) A principal reason for making the payment date of the dividend the same as the date of declaration was to limit the number of shareholders who would receive the MAC dividend in order to avoid the necessity of the preparation and filing of a costly and time-consuming registration statement with the Securities and Exchange Commissions (SEC).

(43) The plan of the B & O to declare and pay a dividend on the same date was made known to outside securities counsel for the B & O, the law firm of Hunton and Williams, in advance of the December 13, 1977, declaration, and they expressed no objection to the proposal.

(44) All of the properties transferred to MAC were still owned by MAC or its subsidiaries except for those which have been sold and as to those properties, an accounting has been made to MAC for the amount of the sale price so that the value of the MAC shares remains the same as it was on December 13, 1977.

(45) Following the declaration of the MAC dividend, the value of the remaining assets of the B & O was substantially over one billion dollars.

(46) In formulating the manner in which the MAC dividend was to be declared, the convertible debentures were considered by the B & O as part of its debt structure.

(47) Prior to the institution of these actions, in June and July of 1977, plaintiff Monroe Guttmann ("Guttmann") wrote to his stockbroker and to the B & O expressing his satisfaction with the policy of the B & O of plowing back earnings into the company. He had also asked information with respect to payment of dividends and was rebuffed except that he was told he would be notified if a dividend was declared.

(48) There was no testimony that plaintiffs would have converted their debentures had they received advance notice of the declaration of the MAC dividend. To this day we do not know if Guttmann and the other plaintiffs wish to convert or not.

(49) The B & O has agreed with the trustee under the Indenture that should plaintiffs prevail on the merits of their claims, all debentureholders similarly situated will be accorded similar treatment as required by any judgment for the plaintiffs.

(50) Class action certification was denied April 3, 1980, by this court.

Additional Findings as to B & O Director-defendants.

(51) The directors of the B & O did not intend to defraud plaintiffs.

(52) The conduct of the directors of the B & O did not constitute an extreme departure from the standard of ordinary care.

(53) Roland W. Donnem, Senior Vice President Law and General Counsel, advised the directors of the B & O that the indenture did not require notice to the convertible debenture holders of the declaration of the MAC dividend.

(54) Roland W. Donnem, Senior Vice President Law and General Counsel, advised the directors of the B & O that it was appropriate to have the declaration and payment of dividend on the same day.

(55) The directors of the B & O were informed of the broad purposes of the management's restructuring program and kept advised as to its general progress at several board meetings during 1977.

(56) Milton S. Eisenhower was not present at the meeting of December 13, 1977, nor did he participate in the December 13, 1977, action of the Board of Directors.

(57) None of the directors of the B & O were on the Restructuring Committee.

(58) Article Eight of the Indenture dated January 1, 1956 states:

> "Immunity of Officers, Directors and Stockholders.
>
> No recourse under or upon any obligation, convenant or agreement of this Indenture, or of any debenture or coupon, shall be had against any incorporator, stockholder, officer or director, as such, past, present or future, of the Company, or of any successor corporation, either directly or through the Company, by the enforcement of any assessment or by any legal or equitable proceeding or by virtue of any statute or otherwise; it being expressly agreed and understood that this Indenture and the obligations issued hereunder are solely corporate obliga-

tions and that no personal liability whatever does or shall attach to, or be incurred by, the incorporators, stockholders, officers or directors, as such, of the Company or of any successor corporation, or any of them, under or by reason of any of the obligations, covenants or agreements contained in this Indenture, or in any of the Debentures or coupons, or implied thereform; and that any and all personal liability of every name and nature, either at common law or in equity, or by statute, or constitution, of every such incorporator, stockholder, officer or director, as such, is hereby expressly waived as a condition of, and in consideration for the execution and issue of the Debentures and coupons."

C. DISCUSSION.

(1) WHAT RELIEF CAN BE GRANTED?

The original complaint as filed by Pittsburgh Terminal Corporation asked only that a preliminary injunction be issued to be made permanent on final hearing enjoining the defendants "from having the dividend of Mid-Allegheny Corporation stock paid to B & O shareholders without first affording plaintiff adequate information and opportunity to determine whether to convert its debentures to common stock and also to receive the dividend. It was further asked that the defendants be enjoined from having dividends paid in the future without first affording plaintiff adequate information and opportunity as to whether to convert and for such other and further relief to be granted as may be necessary and proper.

The amended complaint asks that a detailed description of all assets of Mid-Allegheny Corporation as of December 13, 1977, be supplied, that plaintiff be supplied with a detailed appraisal of the assets of Mid-Allegheny and its subsidiaries and the value of Mid-Allegheny Stock at the close of business on December 13, 1977, that an order be entered permitting plaintiff and other debenture holders to retroactively exercise their right to convert into B & O stock "after receiving the data required in paragraphs 1 and 2". Further prayers were for damages, that an injunction issue against paying future dividends without adequate notice and for costs and attorney's fees and other appropriate relief. The complaint in the Guttmann case, 79-94, contains similar prayers for relief. In other words, what Pittsburgh Terminal and Guttmann, its president, originally sought was sufficient information so that they could make an intelligent determination as to whether or not to convert their debentures into common stock of the B & O so as to receive the dividend in kind in stock of Mid-Allegheny Corporation. The circuit in considering the appeal taken from the award of preliminary injunction commented on this aspect of the case and indicated that it would be sufficient for the defendants to retain sufficient shares of B & O and MAC stock to satisfy plaintiff's claim in the event it is ultimately determined that plaintiff was entitled to reasonable notice of the dividend declaration and information to enable it to decide whether to convert. The circuit went on to say: "Given the limited objective of plaintiff's complaint and defendant's commitment through their counsel, we conclude that there was no irreparable harm giving rise to the need for a preliminary injunction." Since the circuit opinion, the plaintiff in Pittsburgh Terminal and the other plaintiffs in the Guttmann case have raised their sights and are now asking for damages, but we still do not know, despite the large amount of discovery which has taken place in this case, whether or not plaintiffs want to convert their debentures into common stock or not. As was originally foreseen, it was expected it would only take a short period of time for the defendants to gather together information with respect to the values of the assets of the Mid-Allegheny Corporation and, of course, its liabilities to determine at least the book value of MAC stock.

What plaintiffs were complaining about was that they could not make informed decisions and after all this discovery it appears they still do not have the information upon which to make an informed decision as to whether to convert or not. The holdings of Mid-Allegheny Corporation and its subsidiaries are very large as appears from the facts in this case. We have no information as to the value of these assets which could form the basis for any decree. There is nothing to base an award on and without these figures we have no method of determining what damages, if any, have been sustained by the plaintiffs. It is true that the plaintiff has proved general type of damages. Rochez Brothers v. Rhoades, 527 F 2d 891 (3d Cir 1975). Plaintiffs are asking for a detailed description of the assets of Mid-Allegheny Corporation, which apparently we have as a result of discovery, but plaintiffs also go on and demand an appraisal of these assets by the B & O to determine whether or not they should convert. Testimony indicated that there have been no recent appraisals.

We are confronted with vast acreages of property including timber and coal mining properties in several states, and also urban and water front real estate in certain large cities which many railroads acquire over the years. Some of these may be very valuable in the future but to determine the value of them now is going to be exceedingly difficult. The B & O claims that it will take approximately ten years to have an appraisal of the assets of Mid-Allegheny and would cost many millions of dollars. It is doubtful whether the court has the right to order the B & O to make such appraisal and to proceed to expend the money therefor. If this is true, plaintiff will still not have sufficient information to intelligently determine whether or not to convert his stock. In other words, in considering this case, we must also consider the possibility that the suit will be futile.

On the other hand, we could hold that plaintiffs, having been informed as to the items of property held by MAC, can be given the opportunity to make the appraisal themselves. They are entitled, of course, to such data as the B & O has in its possession as to value but the values are so speculative that it is impossible for the court to make an award based upon them. The court felt it was important to make these observations before proceeding with the plaintiffs' right to recover on the merits since even if they do recover on the merits on the question of liability, it is questionable what further we can do for them at least until they make their own decision and tell us whether they wish to convert or not.

(2) THE PURCHASER OR SELLER CONTROVERSY.

The defendants claim that the plaintiff in this case, a holder of convertible debentures who has not converted or attempted to convert them into stock, has no standing as a purchaser or seller under the Federal securities laws. Such finding is necessary in order to give effect to Section 10(b) of the Securities and Exchange Act of 1934 (15 USC 78(j))[1] and violation of Rule 10b-5[2] of the Commission issued thereunder. The court held at the time of its memorandum opinion on the issuance of a preliminary injunction that plaintiffs were holders of convertible debentures which had not converted but that nevertheless the plaintiffs were sellers or purchasers for the purpose of bringing suit in this case under the decision of the Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 US 723 (1975). In Blue Chip, the court held: "Blue Chips, supra, involved the offerees of a stock offering made pursuant to an antitrust consent decree. The offerees had neither purchased nor sold any of the offered shares and the court determined that the rule had been clearly stated in Birnbaum v. Newport Steel Corp., 193 F2d 461 (2d cir 1952) that a suit under 10(b) (5) cannot be brought without the plaintiff having bought or sold *or having contractual rights for purchase or sale of securities.*" The Supreme Court specifically said, however, at page 751:

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[1] 15 USC 78(j) provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility on any national securities

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exchange—* * * "(b) To use or employ, in connection with the *purchase or sale of any security* registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

2. Rule 10b-5 provides: "It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security.*"

> "Unlike respondent, which had no contractual right or duty to purchase Blue Chip's securities, the holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for purposes of Rule 10b-5, not because of a judicial conclusion that they were similarly situated to 'purchasers' or 'sellers', but because the definitional provisions of the 1934 Act themselves grant them such a status."

It would seem that this would be sufficient since the convertible debentures constitute a contract permitting the holder of the same to convert into common stock of the B & O and thus there is a contract right to acquire B & O stock which should be held as a contract of purchase or sale under 10b-5.

The defendants relied strongly upon Broad v. Rockwell International Corp., (N.D.Tex. 1977 Federal Securities Law Reporter, §96193), which has since been affirmed in this respect by the Court of Appeals for the Fifth Circuit at 614 F2d 418 (March 24, 1980).

When this matter was first presented in this case, I specifically declined to follow Broad v. Rockwell and held that the best exposition in this area relative to rights of convertible debenture holders was contained in the decision of Judge Tenney of the Southern District of New York in Green v. Hamilton International Corp., 437 FS 723 (9/29/77).

In the companion case of Lowry and Lowry Zweig Corp v. B & O, W.D.Pa. No. 79-1504 in memorandum opinion dated June 17, 1980, this court again refused to follow Broad v. Rockwell which had been affirmed by the Fifth Circuit on March 24, 1980. At that time we said:

> "We have examined Broad v. Rockwell International Corporation, supra, with care and note that it was a merger case wherein in the merger agreement the debenture holders still retained the right to convert into cash but were denied the right to convert into stock and it was held that they had no standing under Blue Chips."

The court admitted that it had not been willing to extend the definition of purchaser or seller to the extent the Second and Third Circuits had citing, inter alia, Penn Central Securities, 494 F2d 528 (3d cir 1974). As a result the defendant's motion for summary judgment in Lowry was denied and the same is true as to the motions for summary judgment filed by the defendant itself and by the directors.

In view of the fact that we have recently reviewed this whole matter and remain unconvinced that the contract to obtain common stock in exchange for a convertible debenture is not a contract for purchase or sale within the meaning of 10b-5 we again hold that the plaintiffs do have standing as purchasers and/or sellers to bring this suit.

(3) SCIENTER.

The requirement that scienter must be shown by the plaintiff is most clearly enunciated by the Supreme Court in the case of Ernst & Ernst v. Hochfelder, 425 US 185, 47 L Ed 2d 668, 96 S Ct 1375 (1976). In this case, the court clearly held that Section 10(b) of the Act "was addressed to practices that involved some element of scienter and could not be read to impose liability for negligent conduct alone". Referring back to Footnote 12 the court held:

> "In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5."

The court thus held that scienter, which is required for recovery under 10b-5, refers to intent to deceive, manipulate or defraud and the question of liability for recklessness was left open. The matter again appeared in the decision in Santa Fe Industries, Inc. v. Green, 430 US 462, 51 L Ed 2d 480, 97 S Ct 1292 (1977) where the court pointed out that the act itself makes it unlawful for a person to use or employ any manipulative or deceptive device or contrivance in contravention of the commission's rules and that it is required that there be an artifice to defraud which operates or would operate as a fraud or deceit.

While the question of liability for recklessness as opposed to intentional deception or misrepresentation was not answered in Ernst & Ernst, the matter soon came before our circuit in Coleco Industries, Inc. v. Berman, 567 F2d 569 (3d cir 1977) wherein the Court of Appeals for our circuit held that a plaintiff suing under Section 10(b) and Rule 10b-5 must prove injury resulting from a conscious deception or from a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception. The court refused to further refine the bounds of recklessness but held that there was insufficient evidence in the case before it.

The court further went on to define recklessness in McLean v. Alexander, 599 F2d 1190 (3d cir 1979) wherein it held that the burden of proof of scienter was upon the plaintiff and approved the language that scienter requires "a conscious deception or a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception." The court further approved a quotation from the Seventh Circuit in Sunstand Corp. v. Sun Chemical Corp., 553 F2d 1033 (7th cir 1977) that "reckless conduct may be defined as highly unreasonable conduct involving not merely simple or even inexcusable negligence but an extreme departure from the standards of ordinary care which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

Approaching the question in this case from the point of view of the standards thus laid down we do find that the defendants relied upon the advice of their attorneys and also upon the advice of outside counsel, a distinguished firm in the securities field in Richmond, Virginia. It does not appear that any of these attorneys had any apparent conflicting interest although, since all but the Richmond firm held the position of house counsel we must subject their opinions to close scrutiny. At this point we note the case of Drachman v. Harvey, 453 F2d 722 (2d cir 1972) wherein the Second Circuit pointed out that in a situation such as we have here between convertible debenture holders and common stock holders there are conflicting rights and the Board of Directors must give due consideration to the conflicting rights of both parties.

In short, in order to succeed here, we must find that plaintiffs have carried their burden of showing a plan to deceive and deny rights to the convertible debenture holders bearing in mind that the payment of dividends is ordinarily in the discretion of the Board of Directors unless engaged in some illegal enterprise.

In the case at bar, we find no design to depress the stock of B & O despite inferences which the plaintiffs say should be drawn from the evidence in this case. There was a statement in the record that the officers of B & O had stated in 1975 that they would never declare a dividend in common stock of B & O but it must be recognized that this at most would be regarded as a loose statement subject to change by events at any time. We also find that there was a legitimate business purpose in this case. The corporation planned to remove the non-rail assets of B & O from supervision of the Interstate Commerce Commission with respect to financing and also to spin off the non-rail assets so that they could be managed by someone skilled in development of other types of real estate and not hamper the operation of the railroad with plans for unrelated property and the taxes which must be paid thereon and other expenses in connection therewith.

In the preliminary injunction opinion in this case, we stated we could not then determine the question of whether there was intentional fraud or recklessness or mere negligence. Also in plaintiffs' motion for partial summary judgment we said that we could not determine scienter on such a motion since it involved a question of fact as to purpose and intent and also the defense of good faith might be operable. We further indicated that there might be legitimate purposes shown to segregate the non-rail assets from the rail assets. Another business reason for the spin off of the non-rail assets was the fact that ICC restrictions prevented the possibility of forming joint ventures (Tr.265, 397). We thus find that a legitimate business purpose was being followed in declaring this dividend in kind and removing the non-rail assets from the ownership and control of the B & O. See Sec v. Texas Gulf Sulphur, 461 F2d 833 (2d cir 1968). Before all the circumstances had developed, the court indicated at the preliminary injunction that from the showing made there was a likelihood of success on the merits. This was before we had held a full hearing on the merits and all the testimony as to the background and purposes of management was before us. We now hold that there is no evidence of misleading or deception or misrepresentations or use of manipulative devices which would furnish a cause of action under 10b-5. There has been no showing of manipulation by insiders here or trading in shares or offers to trade based upon insiders' information.

We should point out that we do agree with the Fifth Circuit in Broad v. Rockwell International, 614 F2d 418 (5th cir 1980), wherein it was held that reckless conduct describes an extreme departure from standards of ordinary care which presents a danger of misleading buyers or sellers as either known to defendant or is so obvious that defendant must have been aware of it. They held, however, in that case where the rights of convertible debenture holders to participate in a merger were shut off that there was insufficient evidence of scienter to justify recovery.

We will therefore hold for the defendants with respect to the question of scienter. We find that the defendants were engaged in a legitimate business purpose with respect to corporate planning and no intention has been shown by the plaintiffs of intent to defaud them or failure to investigate the procedures before they were adopted. It should be remembered always that there was still a small number of minority shareholders of B & O Railroad Company and they were not deprived of any rights of dividends in kind in Mid-Allegheny Corporation.

(4) CLAIMS UNDER STOCK EXCHANGE PROVISIONS AND LISTING AGREEMENTS.

In the complaint as originally filed in this case, claim was made under the rules of the New York Stock Exchange and the listing agreement between B & O Railroad Company and the Exchange and also for violation of Section 6 of the Securities and Exchange Act of 1934, 15 USC 78(f). While over two years passed nothing much was made of this cause of action until it appeared in a motion by plaintiff for partial summary judgment.

The court denied plaintiff's motion for partial summary judgment based on this claim in the memorandum dated June 24, 1980. In that memorandum, we indicated that we would listen to evidence with respect to this claim; that it appeared in previous cases that actions had been recognized where suits were involved against brokerage houses and the New York Stock Exchange itself. No case had been cited where a security holder could bring suit against his own company for such a cause of action.[3]

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[3] "There is a further claim by plaintiffs for summary judgment that the failure to give notice of the intended declaration of dividend in Mid-Allegheny stock was in violation of the listing agreement claim under the New York Stock Exchange Act and in violation of Section 78(f) of the Securities Act Amendments which became effective in 1975.

"This matter has never been brought up before in the meetings or arguments in this case. Whether it can

We have now received not only the evidence necessary to decide this claim but also, not being satisfied with the argument and brief the first time around, we directed a reargument to be held and the parties have reargued this matter and submitted supplemental briefs and other materials. We conclude that no cause of action on the basis of the exchange rules or the listing agreement can be sustained.

15 USC 78(f) (Section 6 of Securities and Exchange Act of 1934) provides for regulation of the relations between the SEC, stock exchanges and their members. It provides that the exchange must be able to "enforce compliance by its members and persons associated with its members, with the provisions of this chapter, the rules and regulations thereunder, and the rules of the exchange."[4]

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be used as a fresh basis for a cause of action or not, we do not determine at this time but will listen to the evidence with respect thereto. It is noted that a private right of action has been recognized by certain courts. See Hughes v. Dempsey Tegler & Co., Inc., 534 F2d 156 (9th cir 1976). See also Lang v. NY Stock Exchange, 548 F2d 61 (2d cir 1977). In other words the suits in which such rights of action have been recognized are those involving suits against brokerage houses of the New York Stock Exchange itself. The defendants have countered with the allegation that to disclose such material in advance of the director's meeting would require disclosure in violation of other sections of the securities laws.

"In view of the interplay with the various rules, we think and the court is of the opinion it must receive complete evidence on this point."

4. The other subsections of 78f(b) provide in general for regulation of the relationship between the exchange and its members and the discipline of the latter.

It is noted that section 6 does not explicitly grant a private cause of action to persons such as plaintiffs who are security holders of corporations whose securities are listed on the exchange. Such a cause of action, if it exists at all, must be implied under Court v. Ash, 442 US 66 (1975). As many times stated by the court, the question is whether a private cause of action is created expressly or by implication and what must ultimately be determined is whether congress intended to create the private remedy asserted. Transamerica Mortgage Advisers v. Lewis, 444 US 11 (1979); Touche Ross v. Redington, 442 US 560 (1979). It must be admitted as argued by the defendants that in recent years the court has shown a tendency away from a private cause of action where congress, well knowing how to create one, did not do so in so many words. See Collins v. Signetics Corp., 605 F2d 110 (3d cir 1979) where our own circuit held that we must respect recent Supreme Court teachings that militate against excessively expansive readings. In Landy v. Federal Deposit Insurance Corp., 486 F2d 139 (3d cir 1973), our circuit cautioned against expansive reading implying private causes of action. In Jablon v. Dean Whitter & Co., 614 F2d 677 (9th cir 1980), it was held there was no private cause of action to be implied under Section 6 and this has been the holding of our companions in the Eastern District. See Lenowitz v. Philadelphia Stock Exchange, ____ FS ____ (E.D.Pa. Dec. 2, 1980 No. 79-4269); Hoover v. E.F. Hutton & Co., Inc., ____ FS ____ (E.D.Pa. Jun. 24, 1980, No. 79-3475) and Rankl v. Elkins Stroud Supplee and Co., ____ FS ____ (E.D.Pa. June 12, 1980, No. 79-3187).

We therefore hold that the purpose of Section 6 was to regulate the stock exchanges themselves and dealings between them and their broker-members and there is no implied private cause of action under this section.

(b) PRIVATE CAUSE OF ACTION BASED UPON LISTING AGREEMENT.

The listing agreement covering B & O Convertible 4½ Debentures Series A due January 1, 2010, is dated March 22, 1956 and bears the stock exchange No. of A-16166. The debentures as described on page 3 thereof under the heading "Indenture Provisions" provide that they shall be converted at the principal amount thereof into shares of the par value of $100 each in common stock of the company at any time up to 15 days prior to stated maturity or date of redemption at the conversion price of $100 per share. It is provided on page 2 that "the listing agreements set forth in the company's listing applications A-12653 and A-15928 are incorporated herein by reference and made a part hereof."

Referring back to A-12653 dated February 18, 1947, covering certain issues of first mortgage bonds, refunding mortgage bonds and convertible income bonds due February 1, 2010, on pages 11 and 12 are two causes which have caused the court some trouble. Paragraph 5 on page 11 reads as follows:

> "5. The Corporation will not make, nor will it permit any subsidiary directly or indirectly controlled by it to make, any substantial charges against capital surplus, without notifying the Exchange. If so requested by the Exchange, the corporation will submit such charges to stockholders for approval or ratification."

Paragraphs 4 and 5 on page 12 provide as follows:

> "4. The Corporation will give the Exchange at least ten days' notice in advance of the closing of the

> transfer books, or of the taking of a record of its stockholders for any purpose.
>
> "5. The Corporation will publish promptly to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and shall give prompt notice to the Exchange of any such action; and shall afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights; and shall issue all such rights in form approved by the Exchange and will make the same transferable, payable and deliverable in the Borough of Manhattan, in the City of New York."

The court does hold that II(5) on page 11 and III(4) and (5) on page 12 have to do with bookkeeping and operating procedures between the stock exchange and the company and do not confer any private rights of action upon the stockholders. See Hughes v. Dempsey Tegler and Co., 534 F 2d 156 (9th cir 1976); Lang v New York Stock Exchange 548 F 2d 61 (2d cir 1977).

We find no precedent where any court has ever held against a stock exchange based upon a third party beneficiary theory as proposed by the defendants here.

Supplementing the listing agreement is the stock exchange manual which clearly shows that the listing agreements are for setting forth the relations between the companies and the stock exchange and not to give rise to third party causes of action by a security holder against his own company.

As pointed out by the defendants, the third party beneficiary doctrine to apply in any situation must demonstrate (1) that there is a legally enforceable contract, (2) that it was breached and (3) that plaintiff was intended by the makers of the contract to benefit by it. We hold that this contract was to regulate relations between the company and the stock exchange inter se se, that there was no intent to create a third party cause of action in the security holders and, in any event, in this particular case, if notice had been given, it would not have helped the plaintiffs in any respect because they would not have been able to make an intelligent determination as to whether to convert or not to convert within 10 days or whatever time might have been alloted since they have not been able to make that determination within the 3 years this case has been pending. The reason this cannot be done is inherent in the fact that no intelligent evaluation of the stock of Mid-Allegheny Corporation can be made even at this time or, if one is to be made, it will take years and cost millions of dollars to do it. In many respects these paragraphs of the listing agreement are vague in that they do not make it clear whether the exchange must be notified before an action is taken or it can be notified in a reasonable time thereafter. See also Restatement of Contracts Section 133.[5] We agree that there is no evidence of any intent to make a gift from the New York Exchange, the promisee in this agreement to the plaintiffs nor are they creditor beneficiaries under

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5. §133. Definition of Donee Beneficiary, Creditor Beneficiary, Incidental Beneficiary.

(1) Where performance of a promise in a contract will benefit a person other than the promisee, that person is, except as stated in Subsection (3):

the second paragraph of the Restatement. See MacKubin v. Curtis Right Corp., 190 Md 52, 57 A 2d 318 (D. Md. 1948) holding that a security holder suing for violation of a listing agreement as a third party beneficiary is neither a donee beneficiary nor a creditor beneficiary. He is at most an incidental beneficiary with no right of action under Restatement 147[6] against either the promisee or the promisor. The listing agreement itself makes no reference to any action by a security holder as third party beneficiary thereunder and nothing is said concerning a third party beneficiary claim under this listing agreement. It should be further pointed out that the stock exchange itself provides for its own regulation and for penalties against companies which violate their rules and regulations.

(a) a donee beneficiary if it appears from the terms of the promise in view of the accompanying circumstances that the purpose of the promisee in obtaining the promise of all or part of the performance thereof is to make a gift to the beneficiary or to confer upon him a right against the promisor to some performance neither due nor supposed or asserted to be due from the promisee to the beneficiary;

(b) a creditor beneficiary if no purpose to make a gift appears from the terms of the promise in view of the accompanying circumstances and performance of the promise will satisfy an actual or supposed or asserted duty of the promisee to the beneficiary, or a right of the beneficiary against the promisee which has been barred by the Statute of Limitations or by a discharge in bankruptcy, or which is unenforceable because of the Statute of Frauds;

(c) an incidental beneficiary if neither the facts stated in Clause (a) nor those stated in Clause (b) exist.

[6] §147. Effect of a Promise of Incidental Benefit. An incidental beneficiary acquires by virtue of the promise no right against the promisor or the promisee.

We therefore hold that there is no liability under the listing agreement and the same is doubly true with respect to liability on the part of the directors. See A. B. Corporation v. Futrovsky, 267 A 2d 130 (Md. 1970).

It should be noted that ten years after the listing agreement covering the convertible debentures here involved the company suspended trading in its common stock. This is not considered of importance because the listing agreement covering the convertible debentures is still in effect. We therefore hold for the defendants on the matters of the listing agreement and the New York Stock Exchange Rules under Section 6 of the Securities and Exchange Act.

D. CONCLUSIONS OF LAW.

(1) Plaintiffs do have standing to sue under Section 10(b) and Rule 10b-5 because they had a contract to purchase and sell.

(2) Plaintiffs have failed to establish that the corporate defendants had the requisite scienter to establish a violation of Section 10(b) and 10b-5.

(3) The shareowners of the B & O elect its Board of Directors and that Board has the right and obligation to determine whether the assets of the company remain invested with the company or are distributed back to its shareowners. (Tr. 600)

(4) The B & O's declaration of a dividend payable to shareholders of record on the same date as the date of declaration was in accord with the applicable Maryland law.

(5) The B & O's declaration of a dividend payable to shareholders of record on the same date as the date of

declaration was in accord with the terms of the Indenture under which the B & O convertible debentures were issued.

(6) The Indenture does not require that any notice be given debentureholders of a dividend payable in the stock of a company other than the B & O because such a dividend is the equivalent of a cash dividend although payable in kind.

(7) Plaintiffs have failed to prove that they have a right to proceed on an implied cause of action for any breach of any listing agreement with the New York Stock Exchange or the Rules of said Exchange.

(8) Plaintiffs have failed to prove that they were damaged in any way by the declaration of the MAC dividend.

(9) Convertible debentureholders are general creditors of a corporation and have no call on any particular assets of the corporation.

(10) Plaintiffs have failed to prove that they would have converted their debentures had they received advance notice of the declaration of the MAC dividend.

(11) Plaintiffs failed to establish that the defendant directors had the requisite scienter to establish a violation of Section 10(b) and Rule 10b-5.

(12) The defendant directors are relieved of any contractual liability to plaintiffs by virtue of Article Eight of the Indenture.

(13) Plaintiffs failed to establish that director Milton S. Eisenhower, who did not attend or participate in the December 13, 1977, meeting of the B & O Board of

Directors, had the requisite scienter to establish a violation of Section 10(b) and Rule 10b-5.

WILLIAM W. KNOX
U.S. District Judge

Appendix C.

IN THE
UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

PITTSBURGH TERMINAL CORP. v. BALTIMORE & OHIO RAILROAD CO.	Civil Action No. 77-1455
MONROE GUTTMAN, et al v. BALTIMORE & OHIO RAILROAD CO.	Civil Action No. 79-94

JUDGMENT ORDER

AND NOW, to wit, March 10, 1981, for reasons set forth in the accompanying opinion.

IT IS ORDERED that the causes of action set forth in the above entitled cases be and the same hereby are dismissed.

IT IS FURTHER ORDERED that judgment be entered in favor of the defendants and against the plaintiffs.

WILLIAM W. KNOX
U.S. District Judge

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 81-1674 and 81-1675

PITTSBURGH TERMINAL CORPORATION,
Appellant

v.

THE BALTIMORE AND OHIO RAILROAD COMPANY, et al.
(D.C. Civil No. 77-1455)
Appellees

MONROE GUTTMAN, LORETTA GUTTMAN, JANET REES AND EVELYN BITTNER,
Appellants

v.

THE BALTIMORE AND OHIO RAILROAD COMPANY, et al.
(D.C. Civil No. 79-0094)
Appellees

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Present: ADAMS, GIBBONS and GARTH, *Circuit Judges.*

JUDGMENT

These causes came on to be heard on the records from the United States District Court for the Western District of Pennsylvania and were argued by counsel on December 16, 1981.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court entered March 10, 1981, except for the judgment in favor of Milton D. Eisenhower, be, and the same is hereby reversed and the cause remanded to the said district court for a determination of appropriate relief in accordance with the opinion of this Court. It is also now here ordered and adjudged by this Court that that part of the judgment of the said District Court entered March 10, 1981, in favor of Milton D. Eisenhower, be, and the same is hereby affirmed. Costs taxed against all appellees except Milton D. Eisenhower.

ATTEST:
Sally Mrvos
Clerk

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 81-1674 and 81-1675

PITTSBURGH TERMINAL CORPORATION,
Appellant

v.

THE BALTIMORE AND OHIO RAILROAD COMPANY, et al.
(D.C. Civil No. 77-1455)
Appellees

MONROE GUTTMAN, LORETTA GUTTMAN, JANET REES and EVELYN BITTNER,
Appellants

v.

THE BALTIMORE AND OHIO RAILROAD COMPANY, et al.
(D.C. Civil No. 79-0094)
Appellees

SUR PETITION FOR REHEARING

Present: SEITZ, *Chief Judge*, ALDISERT, ADAMS, GIBBONS, HUNTER, GARTH, SLOVITER and BECKER, *Circuit Judges*

The petition for rehearing filed by Appellees, W. James Price, Alonzo G. Decker, Jr., James Parker Nolan, Frederick Dean, Jr., James L. O'Keefe, Gregory S. Devine, Faye A. LaFavre, John K. Stevenson, Hays T. Watkins and Howard E. Simpson in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,
John J. Gibbons
Judge

Dated: July 8, 1982

Appendix E

§240.10b-17 Untimely announcements of record dates.

(a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Act for any issuer of a class of securities publicly traded by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange to fail to give notice in accordance with paragraph (b) of this section of the following actions relating to such class of securities:

(1) A dividend or other distribution in cash or in kind, except an ordinary interest payment on a debt security, but including a dividend or distribution of any security of the same or another issuer;

(2) A stock split or reverse split; or

(3) A rights or other subscription offering.

(b) Notice shall be deemed to have been given in accordance with this section only if:

(1) Gives to the National Association of Securities Dealers, Inc., no later than 10 days prior to the record date involved or, in case of a rights subscription or other offering if such 10 days advance notice is not practical, on or before the record date and in no event later than the effective date of the registration statement to which the offering relates; and such notice includes:

(i) Title of the security to which the declaration relates;

(ii) Date of declaration;

(iii) Date of record for determining holders entitled to receive the dividend or other distribution or to participate in the stock or reverse split;

(iv) Date of payment or distribution or, in the case of a stock or reverse split or rights or other subscription offering, the date of delivery;

(v) For a dividend or other distribution including a stock or reverse split or rights or other subscription offering:

(a) In cash, the amount of cash to be paid or distributed per share, except if exact per share cash distributions cannot be given because of existing conversion rights which may be exercised during the notice period and which may affect the per share cash distribution, then a reasonable approximation of the per share distribution may be provided so long as the actual per share distribution is subsequently provided on the record date.

(b) In the same security, the amount of the security outstanding immediately prior to and immediately following the dividend or distribution and the rate of the dividend or distribution,

(c) In any other security of the same issuer, the amount to be paid or distributed and the rate of the dividend or distribution.

(d) In any security of another issuer, the name of the issuer and title of that security, the amount to be paid or distributed, and the rate of the dividend or distribution and if that security is a right or a warrant, the subscription price.

(e) In any other property (including securities not covered under paragraphs (b)(1)(v) (b) through (d) of this section) the identity of the property and its value and basis for assigning that value;

(vi) Method of settlement of franctional interests;

(vii) Details of any condition which must be satisfied or Government approval which must be secured to enable payment of distribution; and in

(viii) The case of stock or reverse split in addition to the aforementioned information;

(a) The name and address of the transfer or exchange agent; or

(2) The Commission, upon written request or upon its own motion, exempts the issuer from compliance with paragraph (b)(1) of this section either unconditionally or on specified terms or conditions, as not constituting a manipulative or deceptive device or contrivance comprehended within the purpose of this section; or

(3) Given in accordance with procedures of the national securities exchange or exchangers upon which a security of such issuer is registered pursuant to section 12 of the Act which contain requirements substantially comparable to those set forth in paragraph (b)(1) of this section.

(c) The provisions of this rule shall not apply, however, to redeemable securities issued by open-end investment companies and unit investment trusts registered with the Commission under the Investment Company Act of 1940.

Office - Supreme Court, U.S.
FILED
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ALEXANDER L. STEVAS,
CLERK

No. 82-620 and No. 82-622

IN THE

Supreme Court of the United States

October Term, 1982

No. 82-620

W. JAMES PRICE, ALONZO G. DECKER, JR., JAMES PARKER NOLAN, FREDERICK DEANE, JR., JAMES L. O'KEEFE, GREGORY S. DEVINE, FAY A. LeFEVRE, JOHN K. STEVENSON, HAYS T. WATKINS and HOWARD E. SIMPSON, *et al.*,

Petitioners,

vs.

PITTSBURGH TERMINAL CORPORATION,

Respondent,

and

W. JAMES PRICE, *et al.*,

Petitioners,

vs.

MONROE GUTTMANN, LORETTA GUTTMANN,
JANET REES and EVELYN BITTNER,

Respondents.

(Additional Actions inside front cover.)

RESPONSE TO WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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No. 82-622

THE BALTIMORE and OHIO RAILROAD COMPANY,
THE CHESAPEAKE and OHIO RAILWAY COMPANY
and CHESSIE SYSTEM, INC.,
Petitioners.

vs.

PITTSBURGH TERMINAL CORPORATION,
Respondent.

THE BALTIMORE and OHIO RAILROAD COMPANY,
THE CHESAPEAKE and OHIO RAILWAY COMPANY
and CHESSIE SYSTEM, INC.,
Petitioners.

vs.

MONROE GUTTMANN, LORETTA GUTTMANN,
JANET REES and EVELYN BITTNER,
Respondents.

Counter Statement of the Questions Presented

I. Whether, under §10(b) of the Exchange Act and Rule 10b-5:

A. A defense of advice of counsel may rest on unwritten opinions of Defendants' in-house lawyers who never considered those provisions?

B. Alleged reliance on advice of counsel is a defense negating scienter?

II. Whether Defendant issuing corporation and its majority shareholders and directors breached a duty to convertible debentureholders by depriving them of a meaningful opportunity to exercise their conversion rights through concealment of the impending MAC dividend?

A. Whether an Indenture notice clause referring to "any dividend on [the issuer's] common stock payable in stock" required advance notice to convertible debentureholders of a dividend on the issuer's stock, payable in stock of a subsidiary of the issuing company?

B. Whether, for purposes of Rule 10b-5, Rule 10b-17 entitles holders of publicly traded debentures to advance notice of dividends on the issuer's stock?

III. Whether this Court's opinion in *Blue Chip Stamp v. Manor Drug Stores* (holding that the owner of a contractual right to purchase has standing to sue under §10(b) and Rule 10b-5) was correctly applied?

TABLE OF CONTENTS.

Page

Counter Statement of the Questions Presented...... i

Table of Contents iii

Counter Statement of the Case...................... 2

A. Background Facts.......................... 2
B. Procedural History 4

Reasons for Denying the Writ 5

Summary of Argument 5

I. Defendants' acquisition of the MAC stock by concealment and in a manner designed to exclude the minority securityholders violated §10(b) of the Exchange Act 5

A. Defendants' intentionally deceptive conduct is not excused by their claimed reliance on their in-house counsel who never considered §10(b) of the Exchange Act and Rule 10b-5.............................. 7

B. Claimed reliance on advice of counsel does not provide proof of a lack of intent to defraud 9

II. Defendant issuing corporation and its majority shareholders and directors breached a duty to convertible debentureholders by depriving them of a meaningful opportunity to exercise their conversion rights through concealment of the impending MAC dividend 11

Page

A. An indenture notice clause referring to "any dividend on [the issuer's] common stock payable in stock" requires advance notice to the convertible debentureholders of a dividend on the issuer's stock, payable in stock of a subsidiary of the issuing company. 13

B. For purposes of Rule 10b-5, Rule 10b-17 entitles holders of publicly traded debentures to advance notice of dividends on the issuer's stock 15

An analysis of Rule 10b-17........... 17

III. This Court's opinion in *Blue Chip Stamp v. Manor Drug Stores* (holding that the owner of a contractual right to purchase is a statutory purchaser) was correctly applied..... 21

Conclusion.................................. 23

Exhibit A 25

Page

TABLE OF CITATIONS.

Cases:

Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) 6,12
Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171 (2d Cir. 1976) *cert. denied* 434 U.S. 1004 (1978) 7,8,9
Blue Chip Stamp v. Manor Drug Stores, 421 U.S. 723 (1975) i,5,21,22
Broad v. Rockwell, 642 F.2d 929 (5th Cir. 1981) (*en banc*) *cert. denied* 454 U.S. 965 (1981) 11,12,13,14,15
Camp v. Genesco, [1976-77] Fed.Sec.L.Rep. (CCH) Para. 95,473 and Para. 95,679 (S.D.N.Y. 1976) . . . 22
Chiarella v. United States, 445 U.S. 222 (1980) 5,11,17,18,20
Commonality Frat. Trad. Comm'n v. Co. Petro Marketing, 680 F.2d 573 (9th Cir. 1982) 19
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 5,10
Fogel v. Chestnut, 533 F.2d 731 (2d Cir. 1975) *cert. denied* 429 U.S. 824 (1976) 8
Laidlaw v. Organ, 15 U.S. (2 Wheat) 177 (1817) 12
Miley v. Oppenheimer Co., 637 F.2d 318 (9th Cir. 1981) 19
O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F.Supp. 1179 (S.D.N.Y. 1981) 19
Peacock v. Oppenheimer & Co., 1981 Fed.Sec.L.Rep. (CCH) ¶98,212 (N.D. Ill. 1981) 19
Securities and Exchange Commission v. Falstaff Brewing Corp., 629 F.2d 62 (D.C.Cir. 1980) *cert. denied* 449 U.S. 1012 (1980) 9,10

Page

Securities and Exchange Commission v. Manor Nursing Homes Inc., 458 F.2d 1082 (2d Cir. 1972).... 7
Securities and Exchange Commission v. Savoy Industries, Inc., 665 F.2d 1310 (D.D.C. 1981) 10
Singleton v. Wulff, 428 U.S. 106 (1976)............ 19
Sonesta Int'l Hotels Corp. v. Wellington Associates, 483 F.2d 247 (2d Cir. 1973).................... 20
State v. Gaddy, 184 N.E.2d 689 (Ohio Com. Pl. 1962) 18
State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843 (2d Cir. 1981) 15
Stephenson v. Calpine Conifers II, Ltd., 652 F.2d 808 (9th Cir. 1981) 12
Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) 12
Touche Ross & Co. v. Redington, 442 U.S. 560 (1979)... 20
Transamerican Mortgage Advisors Inc. v. Lewis, 444 U.S. 11 (1979) 19
TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) 7
United States v. United States Gypsum Co., 438 U.S. 422 (1978)................................. 10
Universal Athletic Sales v. American Gypsum, 546 F.2d 530 (3d Cir. 1976) 8
Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir. 1975) *cert. denied* 423 U.S. 947 (1975) 14,15,20

Page

Statutes:

Exchange Act, §3(a), 15 U.S.C. §78(c)(a)(13) 22
Exchange Act, §10(b) i,5,6,7,9,12,13,17,18,19,21
Exchange Act, §29 14
Securities Exchange Act Rel. No. 9076, 36 Fed. Reg. 3431 (February 17, 1971) 17
Securities Exchange Act No. 9192, 36 Fed. Reg. 11513 (June 7, 1971) 18

Rules:

Rule 10b-5 . . . . i,7,9,10,15,19,20,22
Rule 10b-17 . . . . i,14,15,16,17,18,19,20

Miscellaneous:

Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 Va. L.Rev. 1, 19 (1976) 8
W. LaFave & A. Scott, *Criminal Law* 196 (1972) 10
L.Loss, 3 *Securities Regulations*, §1483 (2d Ed. 1961) 11

IN THE

Supreme Court of the United States

October Term, 1982

No. 82-620

W. JAMES PRICE, ALONZO G. DECKER, JR., JAMES PARKER NOLAN, FREDERICK DEANE, JR., JAMES L. O'KEEFE, GREGORY S. DEVINE, FAY A. LeFEVRE, JOHN K. STEVENSON, HAYS T. WATKINS and HOWARD E. SIMPSON, *et al.*,

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RESPONSE TO WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Counter Statement of the Case

A. Background Facts

This action, asserting in part violations of the Securities Exchange Act of 1934, arose from the December 1977 declaration of a dividend payable in the stock of Mid-Allegheny Corporation ["MAC"] to common shareholders of Defendant, The Baltimore and Ohio Railroad ["B&O"]. The dividend was declared without prior notice to Plaintiffs, holders of certain B&O convertible debentures, so as to deprive them of the opportunity to exercise their conversion rights and thereby to share in the MAC stock dividend. The Defendants include the B&O; its controlling shareholders, the Chesapeake & Ohio Railroad Company ["C&O"] and the Chessie System, Inc. ["Chessie"]; and fourteen Directors of the B&O.

Plaintiffs own B&O 4-1/2% debentures, which are convertible into 10 shares of B&O common stock for each $1,000 debenture.

Simultaneous with the declaration of the MAC dividend, the B&O transferred substantially all of its non-rail assets to MAC, a wholly owned subsidiary.[1] In declaring the dividend, the Defendant Directors of the B&O set the record date as the date of declaration. The possibility of Plaintiffs converting so as to receive the dividend, and thereby participate in the development of the non-rail assets of the B&O, was thus foreclosed. Concealment of the impending declaration of the MAC dividend enabled the B&O's parent and grandparent, the C&O and the Chessie, to upstream those extremely valuable assets, beyond the reach of the convertible debentureholders.

---

[1] Of the outstanding 2,535,772 shares of B&O common, 99.9% were owned by the C&O whose outstanding stock was 100% owned by Chessie. Twelve (12) of the fourteen (14) Directors of the B&O were also Directors of Chessie and the C&O. The Chairman of the Board of the B&O was Chairman of the Boards of the C&O and Chessie. All the executive officers of the B&O held the same position in the C&O and Chessie.

B. Procedural History

On December 28, 1977, Plaintiff, Pittsburgh Terminal Corporation ["PTC"] commenced an individual action against the Defendant B&O and others to enjoin the payment of the December 1977 MAC dividend. On March 7, 1978, the Trial Court granted Plaintiff PTC a preliminary injunction. See 466 F.Supp. 656 (W.D.Pa. 1978). That injunction was subsequently reversed by the Court of Appeals on July 5, 1978, because Defendant B&O offered to put aside sufficient shares of MAC stock to satisfy Plaintiff's claim. See 578 F.2d 1375 (3d Cir. 1978). On remand, Plaintiff PTC, on February 15, 1979 filed an amended complaint expanding its causes of action and adding a claim for monetary damages. The amended complaint was similar to the complaint filed by PTC's President Monroe Guttmann and others on January 22, 1979.

Following a trial, the Trial Court on March 10, 1981 entered judgment in favor of the Defendants. See 509 F.Supp. 1002 (W.D.Pa. 1981). On June 3, 1982 the Court of Appeals, in a 2 to 1 decision, reversed and remanded for determination of an appropriate remedy. See 680 F.2d 933 (3d Cir. 1982). Thereafter, on July 9, 1982 Defendants' petition for rehearing *en banc* was unanimously denied.

The Corporate and Director Defendants filed separate petitions for writ of certiorari. Because the issues raised by all petitioners are substantially the same Plaintiffs make this their response with respect to both petitions.

REASONS FOR DENYING THE WRIT

Summary of Argument

This case raises no exceptionally unusual or difficult issues appropriate for disposition by this Court. The Courts of Appeals are not in conflict over the questions raised herein, nor does the Court of Appeals' decision conflict with any decision of this Court. The allegedly "conflicting" decision of the Fifth Circuit is readily distinguishable.

At most, Defendants' petitions present yet another opportunity for this Court to restate the scienter standard of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the duty standard of *Chiarella v. United States*, 445 U.S. 222 (1980) and the purchaser-seller standard of *Blue Chip Stamp v. Manor Drug Stores*, 421 U.S. 723 (1975). This Court has already given ample direction as to these issues. On its undisputed facts, the present case does not call for a reassessment of such well-established principles.

I. Defendants' acquisition of the MAC stock by concealment and in a manner designed to exclude the minority securityholders violated §10(b) of the Exchange Act.

The result of Defendants' conduct and concealment of the declaration of the MAC dividend was that the Defendant Chessie immediately became enriched by that portion of MAC which otherwise would have accrued to debentureholders who would have converted had they been timely and adequately informed. The Appellate Court held, on the facts as found by the Trial Court after a five (5) day trial, that Defendants' conduct "was a manipulative or deceptive device or contrivance in violation of Section 10(b)" (22a). This ruling is fully supported by Defendants' admissions that:

> Defendant B&O did not reveal the prospect or possibility of a dividend payment to those who made inquiry concerning the prospects of such dividend payment in 1977.
>
> The prospect or possibility of the payment of a dividend on B&O common stock as part of the Chessie System Corporation Restructuring plan was known to B&O management at the time B&O received inquiries from Plaintiff and other holders of B&O convertible debentures in 1977 about the prospects of dividend declaration by B&O on its common stock.
>
> No attempt was made by Defendants to inform the public holders of the debentures of the proposed declaration of the MAC dividend prior to December 13, 1977.

In fact:

> No provision [ever] was made in the Chessie System Corporation Restructuring Plan [Note this was not the B&O's plan] for the issuance of Mid Allegheny Corporation stock to B&O convertible debenture holders who might convert their debentures to B&O stock
>
> See Request For Admission Nos. 24, 31, 42 and 57.

Significantly it is not disputed that "a reasonable [convertible debentureholder] *might* have considered [the prospect of a MAC dividend] of importance in the making of his [conversion] decision." See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154-55 (1972). Advance disclosure of the MAC dividend with sufficient opportunity for the debentureholders to convert their holdings to stock in time to receive the MAC dividend, would "have assumed actual significance in the deliberations of a reasonable" convertible debentureholder. See *TSC Industries, Inc. vs. Northway, Inc.*, 426 U.S. 438, 449 (1976).

In this Court Defendants seek to escape liability by pressing defenses, all found wanting below, of reliance on advice of counsel, absence of a duty to disclose, and lack of standing to sue. None of these arguments should detain this Court as demonstrated below.

A. Defendants' intentionally deceptive conduct is not excused by their claimed reliance on their in-house counsel who never considered §10(b) of the Exchange Act and Rule 10b-5.

Defendants argue that advice of counsel may in some circumstances constitute a defense to a §10(b) damage action. However, decision of that issue is not appropriate in the present case, since Defendants did not rely on the advice of disinterested counsel. In-house counsel did not consider the Exchange Act in connection with the MAC dividend and outside disinterested counsel were not retained to render a legal opinion on the MAC dividend.

Traditionally, the defense of reliance on the advice of counsel has been held pertinent only in equitable or disciplinary proceedings. *Securities and Exchange Commission v. Manor Nursing Homes Inc.*, 458 F.2d 1082, 1101-02 (2d Cir. 1972) and *Arthur Lipper Corp. v. Securities and Exchange Commission*, 547 F.2d 171, 182 (2d Cir. 1976) *cert. denied* 434 U.S. 1004 (1978).

In an equitable or disciplinary proceeding, the defendant has been required to satisfy at least five prerequisites in order to establish the defense, including that he (i) relied upon the advice of disinterested counsel; (ii) made complete disclosure of all relevant facts to counsel; (iii) requested counsel's advice as to the legality of the proposed conduct; (iv) received advice that such conduct was lawful; and (v) acted in accordance with such advice after it was rendered. See Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases,* 62 Va. L.Rev. 1, 19 (1976).

Courts have uniformly recognized that in-house counsel are not "in a position to give . . . wholly disinterested advice" *Arthur Lipper Corp. v. Securities and Exchange Commission,* 547 F.2d 171, 182 (2d Cir. 1976) *cert. denied* 494 U.S. 1004 (1978). The opinions of Defendants' inside counsel "must be discounted". *Universal Athletic Sales v. American Gypsum,* 546 F.2d 530, 539-40 (3d Cir. 1976). "Reliance . . . from a lawyer having a personal stake adverse to the shareholders affords no protection unless it is right—in which event it is unnecessary to assert the defense of reliance." *Fogel v. Chestnut,* 533 F.2d 731, 749 (2d Cir. 1975) *cert. denied* 429 U.S. 824 (1976).

It is undisputed that here, although outside counsel was utilized for certain limited purposes in connection with the MAC dividend (Corporate Defendants' Petition at pp. 5-6), such outside counsel never rendered any legal opinion that the MAC dividend transaction was lawful.[2]

---

[2] The law firm of Hunton and Williams, which was retained specifically to obtain a "no-action" letter from the Exchange Commission, was neither engaged nor requested to provide an opinion as to the legality of the restructuring transaction with respect to its effect on the B&O debentureholders. While, as the Trial Court found, Hunton and Williams "expressed *no objection* to the [MAC stock dividend] proposal" (emphasis added) (Corporate Defendants' Petition, p. 64a), in fact the firm never rendered any opinion—pro or con—as to the legality of the MAC stock dividend scheme.

Nor did Defendants' in-house counsel ever consider the legality of the transaction under the Exchange Act. They testified that their legal review was limited to the indenture, the listing agreement, Maryland law, and the New York Stock Exchange Manual. Corporate Defendants' Petition at p. 7.[9]

Therefore, Defendants' attempt to raise an advice of counsel defense is not supported by the record and is not properly before this Court.

B. Claimed reliance on advice of counsel does not provide proof of a lack of intent to defraud.

In private damage actions under §10(b) of the Exchange Act, all the Courts have uniformly rejected the defense of advice of counsel. Quite simply, in this case, as in *Arthur Lipper Corp. v. Securities and Exchange Commission, supra*, 547 F.2d 171, 182-83:

> "It is no answer that petitioners may not have realized that this "cunning device" was a fraud.
>
> We likewise reject petitioners' argument that there was no violation of Rule 10b-5 because they acted on the advice of their counsel, Mr. Conwill. . . . Petitioners' reliance on his advice goes not to the violation but to the penalty".

See also *Securities and Exchange Commission v. Falstaff Brewing Corp.*, 629 F.2d 62, 77 (D.C.Cir. 1980)

---

[9] Even Commissioner Bevis Longstreth—whose speech is heavily relied on by the Corporate Defendants (Petition, pp. 14-15) agrees that under the facts of *this* case a reliance on counsel defense lacks merit. See SEC counsel Stillman's January 24, 1982 letter to the Court of Appeals attached hereto as Exhibit "A" wherein it is stated "under the circumstances of this case as found by the District Court the Defendants reliance on advice of counsel is not a defense to violations of Sections 10(b) and Rule 10b-5".

cert. denied 449 U.S. 1012 (1980) and *Securities and Exchange Commission v. Savoy Industries, Inc.*, 665 F.2d 1310, 1314 n. 28 (D.D.C. 1981) ("Compliance with federal securities laws cannot be avoided simply by retaining outside counsel . . .").

Defendants herein raise the claim of reliance on advice of counsel in an attempt to defeat a finding of the requisite intent to deceive.

All parties agree that under *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), a Court must consider the definition of the words "intent" and "deceive" since Rule 10b-5 is limited "to knowing or intentional practices" (footnote omitted). *Id.* at 197-98.

"Intent" is defined as "embracing either the specific requirement of purpose or the more general one of knowledge or awareness." *United States v. United States Gypsum Co.*, 438 U.S. 422, 445 (1978) quoting W. LaFave & A. Scott, *Criminal Law* 196 (1972) as follows:

> "[I]t is now generally accepted that a person who acts (or omits to act) intends a result of his act (or omission) under two quite different circumstances: (1) when he consciously desires that result, whatever the likelihood of that result happening from his conduct; and (2) when he knows that the result is practically certain to follow from his conduct, whatever his desire may be as to that result." *Id.* at 445.

With reference to the meaning of the word "deceive":

> ". . . *Webster's New International Dictionary* (2d Ed. 1934) defines "deceive" as inter alia: "to cause to believe the false, or disbelieve the truth." "Deceptive" means "tending to deceive; having the power

> to mislead; as, a deceptive appearance." *Id.* "To deceive," then, refers to the *effect* of conduct on the observer; "deceptive", on the other hand, refers more to a *quality* of the conduct itself, to wit, its *propensity* to deceive. (Footnote omitted) *Klamberg v. Roth*, 473 F.Supp. 544, 550 (S.D.N.Y. 1979).

In this case, Defendants intended to conceal the MAC dividend from Plaintiffs and had knowledge that, if Plaintiffs did not receive advance notice of the MAC dividend, they would lose the opportunity to participate in the development of the B&O's non-rail assets. Defendants had the requisite intent to deceive, and the claimed reliance on the advice of counsel is patently irrelevant.

II. Defendant issuing corporation and its majority shareholders and directors breached a duty to convertible debentureholders by depriving them of a meaningful opportunity to exercise their conversion rights through concealment of the impending MAC dividend.

Defendants principally rely on the Fifth Circuit decision in *Broad v. Rockwell*, 642 F.2d 929 (5th Cir. 1981) (*en banc*) *cert. denied* 454 U.S. 965 (1981) to support its allegation that the Third Circuit failed to follow this Court's "duty" criteria in *Chiarella v. United States*, 445 U.S. 222 (1980). However, *Broad* supports the Plaintiffs', not the Defendants', legal position. In *Broad*, 642 F.2d at 958, defendant Rockwell *conceded* a fiduciary relationship with its convertible debentureholders.[4]

---

[4] Compare and contrast a broker's duty to third parties when they trade. L.Loss, 3 *Securities Regulations*, §1483 (2d Ed. 1961) ("the theory is that even a dealer at arm's length impliedly represents, when he hangs out his shingle, that he will deal fairly with the public. . ."). Defendants herein fail to admit that when they "hang out" their debentures for public trading, they too have a duty to act fairly. *Cf. Chiarella v. United States*, 445 U.S. at 226-28, expressly recognizing that the customary duties of corporate directors to securityholders can provide a basis for the duty of disclosure.

Whether or not a duty to disclose exists under §10(b) of the Exchange Act is only resolved by a careful consideration of numerous factors. See, *e.g., Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 813 (9th Cir. 1981) wherein the Court recently held:

> "... [T]he scope of a defendant's duty under Rule 10b-5 should be determined by considering five factors: (1) the relationship of the defendant to the plaintiff; (2) the defendant's access to information, compared to that of plaintiff; (3) the benefit the defendant derived from the relationship; (4) the awareness by the defendant of the plaintiff's reliance on him or her; and (5) the defendant's activity in initiating the securities transaction in question." (footnote omitted) *Id.* at 813.[8]

Corporate duties may even extend to creditors. *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971).

After considering the above factors, the Court of Appeals here correctly held, as did the Court in *Broad*, that a corporation owes its convertible debentureholders a "duty of good *faith and fair dealing*". (Emphasis added) *Broad*, 614 F.2d at 430, *aff'd* on this point 642 F.2d at 958.

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[8] In dissenting, Judge Adams contended you are only entitled to receive what you "bargained for" (49a). Such a principle was not even the common law, but only the law "where the means of intelligence [were] equally accessible to both parties ..." *Laidlaw v. Organ*, 15 U.S. (2 Wheat) 177 (1817). Also see *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) recognizing that the Exchange Act's basic purpose was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor...". *Id.* at 151.

A. An indenture notice clause referring to "any dividend on [the issuer's] common stock payable in stock" requires advance notice to the convertible debentureholders of a dividend on the issuer's stock, payable in stock of a subsidiary of the issuing company.

In *Broad v. Rockwell*, 642 F.2d 929 (5th Cir. 1981) (*en banc*) *cert. denied* 454 U.S. 965 (1981) plaintiffs were holders of convertible debentures issued by Collins Radio Company. In 1973, after having acquired 75% of the outstanding Collins common stock by a tender offer, Rockwell affected a short-form merger upon the non-tendering minority shareholders. In connection with the merger of Collins into Rockwell, Rockwell assumed Collins' obligation to its debentureholders and entered into a supplemental indenture agreement with the indenture trustee, providing that debentureholders would have the right to convert into the same thing (cash) which holders of Collins common stock received in the merger. The debentureholders claimed, in part, that defendants' failure to disclose a material fact (*i.e.*, that in the event of a merger, plaintiffs' conversion rights would be the same as that of shareholders) was a violation of §10(b) of the Exchange Act. *Id.* at 960. The Court, in *Broad*, rejected the plaintiffs' legal position and found that the indenture "unambiguously sets out the conversion rights of the holders of the Debentures in the event of a merger. . ." (p. 955) and that it "was available to anyone who cared to look at the indenture". *Id.* at 960. The Court in *Broad* concluded that there was no fraud or deception, because Defendants "merely carried out their contractual obligations". *Id.* at 963.

In this case Plaintiffs have consistently maintained that the B&O Indenture (Article V, Section 12) explicitly required advance notice to the debentureholders of the MAC dividend. While Defendants dispute this[6] and neither of the prevailing opinions below addresses that point, this state law issue could become a threshold question should this Court undertake a review of the merits.

Even accepting, however, the Defendants' position that the Indenture is silent on that subject, *Broad* still does not support Defendants' position in this case. *Broad* held that the defendants' conduct was *mandated* by the indenture. Defendants here can point to no such mandate. Moreover, in this case the Indenture, if read as not explicitly requiring notice of the dividend, should be deemed enlarged or superseded by the notice provisions of SEC Rule 10b-17 and the Listing Agreement; see Exchange Act, §29 ("Validity of Contracts").[7]

In addition, Defendants overlook the crucial fact that the Court in *Broad* was concerned with a substantial right "inherent in the investment" to obtain only cash upon a merger, as opposed to an "unsatisfactory notice procedure". *Broad*, 642 F.2d at 957-58 quoting *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1385

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[6] The narrow question is whether the Indenture phrase "dividend on [B&O's] common stock payable in stock" encompasses the MAC dividend, as Plaintiffs contend, or only a dividend in B&O's shares, as Defendants contend.

[7] Moreover, in *Broad*, debentureholders were entitled to recover on conversion exactly what the common shareholders received. In contrast, here, the B&O debentureholders were foreclosed from recovering on conversion what the B&O common shareholders received, *i.e.*, the MAC shares.

(2d Cir. 1975) *cert. denied* 423 U.S. 947 (1975).[9] In this case, unlike *Broad*, but like *Van Gemert*, the plaintiffs are concerned about an "unsatisfactory notice procedure."

There is no conflict between the Fifth Circuit's decision in *Broad* and this case. In this case, as in *Broad*, certiorari should be denied.

B. For purposes of Rule 10b-5, Rule 10b-17 entitles holders of publicly traded debentures to advance notice of dividends on the issuer's stock.

Defendants' view of their advance notice duty is myopic.

Plaintiffs argued in the Courts below that there were at least four independent sources of duty that the Defendants violated when they failed to give them advance notice:

1. Defendants' indenture;
2. Defendants' listing agreement;
3. Maryland statutory law; and
4. Section 10(b) of the Exchange Act.

Plaintiffs contended, *inter alia*, that under Rule 10b-17, Defendants had a duty to speak, and that the breach of that duty was fraudulent under Rule 10b-5.

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[9] The importance of meaningful notice to the convertible debentureholders is well recognized.

> "[T]he debentureholder relies on the opportunity to make a proper conversion on due notice. Any loss occurring to him from failure to convert, as here, is not from a risk inherent in his investment but rather from unsatisfactory notice procedures." *Broad*, 642 F.2d at 957-58 quoting *Van Gemert*, 520 F.2d at 1385.

And "inadequate notice . . . to debentureholders may render valueless the investors' interest" (footnote omitted) *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 854 (2d Cir. 1981).

Judge Gibbons, announcing the judgment of the Court, held that Defendants had a "duty to speak" under "[1] Rule 10b-17, [2] the Maryland law of fiduciary obligations and [3] the New York law of contracts [indentures]" (19a).[9] Judge Garth, concurring in part, held that he would "predicate [Defendants'] duty to disclose the [MAC] dividend solely on the provisions of Rule 10b-17 . . ." (23a) and therefore did not find it necessary to decide whether a duty to disclose arose from other sources.[10]

Defendants request this Court to grant certiorari and hold that Defendants had no duty to disclose under Rule 10b-17. Plaintiffs respectfully submit that since Defendants' duty under Rule 10b-17 is clear, further consideration by this Court or the Court of Appeals on whether a duty under the indenture, listing agreement, or the law of Maryland exists is unwarranted.

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[9] Judge Gibbons also noted that the "convertible debentures were listed on the NYSE, and that the listing agreement applicable to them imposed on B&O the affirmative duties . . .(b) to 'afford holders of its securities listed on the Exchange [a] proper period within which to record their interests and exercise their rights." (17a) Judge Gibbons, however, declined to look to the listing agreement as a source of the duty owed to Plaintiffs. (19a)

[10] Judge Garth found it unnecessary to consider "the question whether the Defendants had a duty to disclose under the New York Stock Exchange (NYSE) listing agreement, the Maryland law of fiduciary obligations, or the New York law of contracts." (23a) Also see 29(a). However, he did state that the Defendants' listing agreement was applicable to this case: "By its terms, the NYSE listing agreement unquestionably includes any action taken, including the distribution of dividends, which affects convertible debentures." (26a, n. 3)

An analysis of Rule 10b-17

Rule 10b-17, entitled "Untimely announcements of record dates", provides that notice must be given to the Exchange ten days prior to the declaration of a dividend relating to any publicly traded security.[11] The failure to provide this notice constitutes a "manipulative or deceptive device" within the prohibitions of Section 10(b). Rule 10b-17 provides *inter alia:*

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Act for any issuer of a class of securities publicly traded by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange to fail to give notice in accordance with paragraph (b) of this section of the following actions relating to such class of securities:
>
> > (1) A dividend or other distribution in cash or in kind, except an ordinary interest payment on a debt security, but including a dividend or distribution of any security of the same or another issuer;

The Commission releases issued when Rule 10b-17 was proposed indicate that the notice requirement was to protect purchasers (like Plaintiffs) and sellers of all publicly traded securities. See Securities Exchange Act Rel. No. 9076, 36 Fed. Reg. 3431 (February 17, 1971) (Purpose of Rule 10b-17 was "to require companies whose securities are publicly traded to furnish public investors with timely advance notice of the right to receive dividend and other rights which accrue to holders of record"). The Commission also noted that "belated declarations of . . . dividends [could have] a manipulative effect on the market". See also Securities Exchange Act No. 9192, 36 Fed. Reg. 11513 (June 7, 1971) ("[T]he failure to make a timely announcement of the record date has had a misleading and deceptive effect on both the broker-dealer community and the investing public.")[12]

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[11] This Court, in finding no duty in *Chiarella*, attributed significance to the fact that neither Congress nor the Commission had ever promulgated a general "parity of information rule", 445 U.S. at 233. Here, the Commission has promulgated a rule (Rule 10b-17) governing the exact situation presented by this case.

Defendants contend that Rule 10b-17 is not applicable to this case for at least four reasons:

First: Since the MAC dividend was declared on the non-publicly traded B&O common stock, Rule 10b-17 is inapplicable.

Answer: The convertible debentures are publicly traded securities. The MAC dividend was "relating to" the publicly traded convertible debentures of the B&O.[13]

Second: The Rule 10b-17 duty to speak issue was not raised before the Trial Court.

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[12] Judge Adams would limit Rule 10b-17 to a mere recordkeeping requirement. (46a-48a). However, the Commission's primary purpose in promulgating that rule was to prevent fraud, as is apparent from the Rule itself which defines the failure to give notice as a "manipulative or deceptive device" *per se*. That Rule clearly falls within the "catch-all" provisions for fraud in §10(b) of the Exchange Act. *Chiarella, supra,* 445 U.S. at 234-35.

[13] In this case as in *State v. Gaddy,* 184 N.E.2d 689 (Ohio Com. Pl. 1962):

> "* * * it is commonly understood that 'relating to' embraces much more than such words as 'directly connected to' or 'a part of'. We constantly use the words 'relating to' in many circumstances where time and again we find an event or a status often leading to or in our experience being followed by a common consequence."

Answer: The Rule 10b-17 duty issue was raised *before* trial [Plaintiffs' Brief In Support Of Motion For Summary Judgment, p. 13] as well as immediately *after* trial in Plaintiffs' Proposed Conclusions of Law, p. 9. The Rule 10b-17 duty was fully, completely and forcefully presented to the Trial Court.[14]

Third: Rule 10b-17 does not create any duty owed to Plaintiffs, but only to the Exchange.

Answer: Duties owed to the Exchange are relevant in determining standards of disclosure under §10(b) and Rule 10b-5. *Peacock v. Oppenheimer & Co.,* 1981 Fed.Sec.L.Rep. (CCH) ¶98,212 (N.D. Ill. 1981) citing *Miley v. Oppenheimer Co.,* 637 F.2d 318, 333 (9th Cir. 1981) and numerous other cases. See also *O'Connor & Assoc. v. Dean Witter Reynolds, Inc.,* 529 F.Supp. 1179 (S.D.N.Y. 1981) "[U]nder the *Newmann* [664 F.2d 12 (2d Cir. 1981)] rationale, because their trading . . . breached fiduciary duties owed to other parties, the alleged conduct constituted a fraudulent practice within the meaning of the securities laws." *Id.* at 1185).

Fourth: Rule 10b-17 does not create a private cause of action.

Answer: Plaintiffs have never claimed that Rule 10b-17 creates a private cause of action. Plaintiffs claim only that Rule 10b-17 sets forth a standard upon which to judge Defendants' conduct under Rule 10b-5. Therefore this Court's private right of action cases like *Transamerican Mortgage Advisors Inc. v. Lewis,* 444 U.S. 11 (1979) and

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[14] Moreover, at the discretion of the Court of Appeals a purely legal issue may be considered for the first time on appeal. *Singleton v. Wulff,* 428 U.S. 106, 121 (1976) and *Commonality Frat. Trad. Comm'n v. Co. Petro Marketing,* 680 F.2d 573, 581 (9th Cir. 1982).

Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) are inapplicable. As noted by the Court of Appeals "we do not look to . . . Rule 10b-17, the Maryland law of fiduciary obligations and the New York law of contracts as sources of independent causes of action . . . we look to them as sources of a duty to speak. . ." (19a). This is consistent with the analysis in *Chiarella* where this Court looked to common law fiduciary principles, not as an independent cause of action, but as the source of a duty to speak, breach of which could lead to Rule 10b-5 liability.

Plaintiffs had the right to rely on "the protection of certain Exchange requirements." *Sonesta Int'l Hotels Corp. v. Wellington Associates*, 483 F.2d 247, 254 (2d Cir. 1973). Or as stated by the Court in *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1381 (2d Cir.) *cert. denied* 423 U.S. 947 (1975):

> [I]t is held out to the investing public that by dealing in securities listed on the New York Stock Exchange the investor will be dealt with fairly and pursuant to law. This would be particularly true as to the convertible securities market which differs from the market for other corporate debt in that it is composed primarily of individuals. (Emphasis added)

Likewise, the Plaintiffs had the right to rely on the duties owed the Exchange on listed securities, *i.e.*, the duty to provide notice to the Exchange (as mandated by Rule 10b-17), which notice would then have been disseminated to the public.[18] Defendants' violation of Rule 10b-17 was fraudulent under Rule 10b-5.

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[18] As succinctly stated by the Court of Appeals in *Van Gemert v. Boeing Co., supra*, 520 F.2d at 1383:

> What one buys when purchasing a convertible debenture in addition to the debt obligation of the company incurred thereby is

(Footnote continued on following page)

III. This Court's opinion in *Blue Chip Stamp v. Manor Drug Stores* (holding that the owner of a contractual right to purchase is a statutory purchaser) was correctly applied.

In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), this Court emphasized that "the wording of §10(b), making fraud *in connection with the purchase or sale of a security* a violation of the Act, is surely strained when construed to provide a cause of action, not to purchasers or sellers of securities, but to the world at large." (Emphasis added) *Id.* at 733, n. 5. But this Court went on to recognize that a party with a *contractual* right to purchase has standing as well as an actual purchaser:

> [The Court of Appeals] noted that prior cases have held that persons owning contractual rights to buy or sell securities are *not* excluded by the *Birnbaum* rule. (Emphasis added) *Id.* at 749.

This Court explicitly commented on the difference, under §10(b), between a person with and a person without a contractual right to purchase:

> A contract to purchase or sell securities is expressly defined by §3(a) of the 1934 Act, 15 U.S.C. §78c(a) [15 U.S.C. §78c(a)(13)] as a purchase or sale of

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(Footnote continued from preceding page)

> principally the expectation that the stock will increase sufficiently in value that the conversion right will make the debenture worth more than the debt. *The debentureholder relies on the opportunity to make a proper conversion on due notice... The debentureholder's expectancy is that he will receive reasonable notice and it is his reliance on this expectancy that the courts will protect.* (Emphasis added)

The conduct of the Defendants in this case violated the Defendants' duty to provide convertible debentureholders with the notice necessary to enable them to make use of the conversion right for which they had paid.

> securities for the purposes of that Act. *Unlike respondent, which had no contractual right or duty to purchase Blue Chip's securities, the holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as "purchasers" or "sellers" of securities for purposes of Rule 10b-5,* not because of a judicial conclusion that they were similarly situated to "purchasers" or "sellers", but because the definitional provisions of the 1934 Act themselves grant them such a status. (Emphasis added) (Footnote omitted) *Id.* at 750-51.

Also see *Camp v. Genesco,* [1976-77] Fed.Sec.L.Rep. (CCH) Para. 95,473 and Para. 95,679 (S.D.N.Y. 1976).

As holders of convertible debentures Plaintiffs have a contractual right to acquire B&O common stock, and are therefore granted the status of "purchasers" for the purposes of Rule 10b-5 by the definitional provisions of the Act of 1934. The fact that Plaintiffs have not yet redeemed or sold their debentures does not affect their protection under Rule 10b-5 as thwarted purchasers. Moreover, Defendants' conduct, which deprived Plaintiffs of a meaningful opportunity to "purchase" B&O stock and to participate in the MAC dividend, constituted fraud "in connection with the purchase or sale of any security." See Rule 10b-5. For purposes of this case—substituting the statutory definition of "purchase" contained in §3(a) of the Exchange Act, 15 U.S.C. §78(c)(a)(13)—the issue may be stated as follows: Whether the acts or omissions of Defendants operated as a fraud upon Plaintiffs "in connection" with a "contract to buy, purchase, or otherwise acquire" an equity security.

This Court's opinion in *Blue Chip Stamp & Manor Drug Stores* was correctly applied.

Conclusion

There is no conflict between this case and any other appellate court decision. The Court's standards for determining scienter, duty and standing were followed by the Court of Appeals. The petitions for certiorari should be denied.

Respectfully submitted,

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EXHIBIT A

(Seal)

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

January 24, 1982

Sally Mrvos, Clerk
United States Court of Appeals
for the Third Circuit
21400 United States Courthouse
Independence Mall West
601 Market Street
Philadelphia, PA 19106

Re: *Pittsburgh Terminal Corp., et al.* v. *The Baltimore & Ohio Railroad Co., et al.*, Nos. 81-1674, 81-1675, 81-1976

Dear Ms. Mrvos:

Pursuant to Rule 28(j) of the Federal Rules of Appellate Procedure, the Securities and Exchange Commission, which filed an *amicus curiae* brief in this case, submits this letter in response to a letter of January 18, 1982 submitted by the appellees. Enclosed with the appellees' letter was a copy of a speech given on December 4, 1981 by Securities and Exchange Commissioner Bevis Longstreth, as reprinted in the CCH Federal Securities Law Reporter at ¶ 83,063. The appellees' letter states that in his speech Commissioner Longstreth "disavowed the position expounded by counsel for the SEC in its *Amicus* Brief."

Contrary to the suggestion implicit in appellees' reference to "the position expounded by counsel for the SEC," the views expressed in the Commission's *amicus curiae* brief are those of the Commission itself, which determined to participate *amicus curiae* in this case and reviewed the brief.

In addition, Commissioner Longstreth's speech dealt with only one of the issues addressed in the Commission's brief—reliance on advice of counsel. And even with respect to that issue, it is clear from his speech—and he has authorized us to state—that his views differ from those in the Commission's brief only with respect to whether reliance on advice of counsel is relevant in an omissions case where the advice goes to the existence of a legal duty to disclose. Commissioner Longstreth has also authorized us to state that he agrees with the position in the Commission's brief that a reliance-on-counsel defense is unavailable where counsel's advice was not disinterested or was incomplete, and that he agrees with the brief's ultimate conclusion that, under the circumstances of this case as found by the district court, the defendants' reliance on advice of counsel is not a defense to violations of Section 10(b) and Rule 10b-5.

Finally, Commissioner Longstreth has asked us to point out that his speech, as printed in the official Commission News release (a copy of which is enclosed), contains the following qualification in a footnote on the first page:

Exhibit A—Letter Dated January 24, 1982.

> "The views expressed in this paper are my own and do not necessarily represent those of the Commission, my fellow Commissioners, or the staff."

CCH failed to include that qualification in its reprint of the speech.

I am enclosing three additional copies of this letter and of the Commission News release containing Commissioner Longstreth's speech.

Sincerely,

JACOB H. STILLMAN
Jacob H. Stillman
Associate General Counsel

Enclosures

cc (w/encl.):

Richard T. Wentley, Esq.
Robert B. Block, Esq.
John J. Repcheck, Esq.
Leonard M. Mendelson, Esq.
Michael P. Malakoff, Esq.